LAW REFORM COMMISSION OF BRITISH COLUMBIA

REPORT ON
COMPETING RIGHTS TO MINGLED PROPERTY:
TRACING AND THE RULE IN CLAYTON'S CASE

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TO THE HONOURABLE BRIAN R.D. SMITH, Q.C.,
ATTORNEY GENERAL OF THE PROVINCE OF BRITISH COLUMBIA:

The Law Reform Commission of British Columbia has the honour to present the following:

REPORT ON COMPETING RIGHTS TO MINGLED PROPERTY: TRACING AND THE RULE IN CLAYTON'S CASE

When trust monies are mingled in a single trust account, and the balance falls below the amount required to satisfy or repay the trust monies, the courts may determine entitlement to the fund by applying

the rule in *Clayton's Case; Devaynes* v. *Noble* (1816), 1 Mer. 572, 35 E.R. 767. This rule provides a presumption that the sum first paid into the account is the sum first paid out.

The rule works well for many purposes but it operates harshly when the monies of more than one beneficiary are involved in a mixed fund which is depleted and the competition is between innocent parties. A beneficiary, merely because his money was deposited first in time, may be required to bear the entire shortfall.

In this Report we make recommendations to modify the application of the rule in *Clayton's* Case. We also examine the principles governing tracing in equity and make recommendations directed toward resolving anomalies in that area of the law.

CHAPTER I INTRODUCTION

A. Revolving Credit Arrangements

Revolving credit arrangements, although not generally known by that designation, are a familiar part of everyday life. The essence of a revolving credit arrangement is a debt which is expected to continue over a period of time and to fluctuate in amount as payments are made toward discharging the debt and further extensions of credit are advanced during the life of the arrangement.

The ordinary citizen may be a party to a revolving credit arrangement either as a debtor or as a creditor. His involvement as a debtor may be as the user of a charge account with a department store, as the holder of a credit card or as a business borrower who has a "line of credit" with a commercial lender.

His involvement as a creditor is most often as a depositor of money with an institution that is expected to repay it, disburse it for the benefit of the depositor or provide other value in the future. The commonest example is a deposit with a bank, trust company or credit union. Other examples are monies paid in trust to a solicitor or money deposited with a public utility or other supplier, to secure prompt payment of future bills.

Very few problems arise from revolving credit arrangements, beyond miscellaneous accounting or computer errors. For example, transactions on a bank account are very simply performed. Money in the form of cash or a cheque is deposited into a bank account and at some later time withdrawn.

This Report concerns problems that arise from time to time when money belonging to two or more people is mingled in a single account. The operative concept here is that the money belongs to two or more people. If A borrows money from B, that money belongs to A. Although A may have to repay a similar amount to B, ownership of the actual money borrowed has passed to A. If A deposits that money into his bank account, which has a credit balance, he is not mixing money that belongs to two or more people. Suppose, however, that A steals B's money and deposits it in his own account. Property in the money has not passed from B to A. B's money has been mixed with A's. Can B recover that money from the bank account?

One might guess that B should be entitled to the return of his money. For example, if A steals B's television set, provided it can be found, B is entitled to its return. He is entitled to its return because he still owns it. Suppose, however, that A places the television set in a room filled with television sets. Even though B still owns the television set, he is entitled to its return only if he can identify it. If B cannot identify his television set, should he be entitled to recover any television set in the room? The law says no. B has other remedies against A but he cannot take any television set other than his own. The key here is that a person can recover his property provided he can find and identify it.

If we apply this principle to the question we first raised can B recover his money from the bank account in which it was mixed with A's money it is clear that B will never be able to identify the actual money deposited. The money A deposited was credited to his account, but the currency was placed in a teller's drawer and mixed with deposits made by many other depositors. Many conceptual problems arise from depositing money in a bank account. (a) the common law viewed property "materialistically," and could comprehend only the physical identity of property: "It could treat a person's money as identifiable so long as it had not become mixed with other money. It could treat as identifiable with the money other kinds of property acquired by means of it, provided that there was no admixture of other money." (*Re Diplock*, [1948] Ch. 465, per Lord Greene at 518);

(b) only limited remedies were available at common law: *e.g.*, the common law knew no action for conversion of money and the only means available for recovery of money was an action for conversion of the cheque by which the money was obtained: recovery of money was an action for conversion of the cheque by which the money was obtained: *see* Lord Denning, "The Recovery of Money," (1949) 65 L.Q.R. 37;

(c) title to currency passes easily, and specific notes and coins are virtually impossible to identify. Originally it was thought that, while goods might be traced, money "must first answer the debts of a superior creditor:" *Whitecomb* v. *Jacob*, (1710) 1 Salk. 160, 161, 91 E.R. 149; *see also L'Apostre* v. *Le Plaistrier*, as cited in *Copemann* v. *Gallant*, (1708) 1 P. Wms. 314, 318, 24 E.R. 404, 406; *Godfrey* v. *Furzo*, (1733) 3 P. Wms. 185, 24 E.R. 1022; *Winch* v. *Keeley*, (1787) 1 T.R. 619, 99 E.R. 1284; later it was conceded that money received from the conversion of goods was traceable: *Ryall* v. *Rolle*, (1749) 1 Ak. 165, 172, 26 E.R. 107; *Scott* v. *Surman*, (1742) Willes 400, 404, 125 E.R. 1235, 1237, as were goods purchased with that money: *Taylor* v. *Plumer*, (1815) 3 M. & S. 562, 105 E.R. 721.

This is the position at law. For the position in equity, *see infra*, Chapter II, s. I and M. For the distinction between law and equity, *see infra*, Chapter II, s. B. Depending on the circumstances, B may be permitted to look to that fund for recovery of his money, notwithstanding that he cannot identify the actual currency deposited. It is assumed in some cases that by A's deposit, B acquires a proprietary interest in the debt owed by the bank to A, represented by the credit balance in the bank account.

The matter becomes complicated, however, when A makes withdrawals so that less money than that belonging to B is left in the account. Is B entitled to the money remaining? If the account is exhausted and A subsequently makes deposits, is B entitled to any of the money in the bank account? If money belonging to C is deposited into that account, what happens to B's entitlement?

Many of these questions are resolved by applying the rule in *Clayton's Case*. That rule raises a presumption that the sum first paid into the account is the sum first paid out, or that the first item on the debit side of an account is discharged or reduced by the first item on the credit side. In this way money can be "identified." Since the most common example of revolving credit arrangements is probably a bank account, we will use that in most of our examples in this Report. It should be remembered, however, that a bank account is only one kind of revolving credit arrangement to which the rule in *Clayton's Case* applies.

The rule in *Clayton's Case* is based upon elementary accounting principles, and in the usual course it is a practical and accurate description of banking practice. In some cases, however, it works very unfairly. A recurring fact pattern is the trustee who deposits into one account money he holds on behalf of two or more people. Money is withdrawn and squandered. The account's balance falls below the amount required to satisfy or repay the money belonging to the trustee's beneficiaries. By applying the rule in *Clayton's Case*, one of the beneficiaries may be required to bear the entire shortfall merely because his money was deposited first in time.

Two common kinds of mixed trust funds are syndicated mortgages and private mutual funds. A private mutual fund consists of pooled assets which are then invested and the profits and losses are shared by the contributors to the fund. Many investment clubs operate that way. That is also true of common trust funds or pooled funds for R.R.S.P. investments, administered by trust companies and banks. In the case of any of these funds, if a shortfall occurs (other than from investment losses) the loss will be apportioned by applying the rule in *Clayton's Case*. The rule has been criticized on many occasions. In *Re Walter J. Schmidt & Co.*,If it is possible to identify a principal's money with an asset purchased exclusively by means of it we see no reason for drawing a distinction between a chose in action such as a banker's debt to his customer and any other asset. If the principal can ratify the acquisition of the one, we see no reason for supposing that he cannot ratify the acquisition of the other.

See also Waters, *Law of Trusts in Canada*, (1974) at 895; Goff & Jones, Law of Restitution (2nd ed., 1978), at 58. an American case decided in 1923, it was said:

> There is no reason in law or justice why his [the trustee's] depredations upon the fund should not be borne equally between them [the beneficiaries]. 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*. 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.

In the recent Ontario case of *Re Law Society of Upper Canada and Riviera Motel (Kitchener) Ltd*., a lawyer mixed money he held in trust and spent part of it for his own purposes. After applying the rule, Pennell, J., said:

> I add a concluding observation, though I cannot tell whether it will be useful. To use borrowed language, I find it difficult to resist the argument "that it would have been preferable, if, instead of juggling with the accidental time sequence of events, the court had proportioned the loss between the clients according to the amounts due them respectively": Waters, *Law of Trusts in Canada (1974)*, p. 895. At the behest of counsel for the respondents Hykawy, I transmit his plea that the Law Society seek legislative action that would confer upon them a discretion in allocating remaining trust assets rather than being compelled to apply the inflexible formula sustained by this Court; I think he is entitled to have his plea plainly published.

In this Report we examine competing rights to mingled property. That examination involves a review of the law of tracing or following property, but the principle focus of this Report is the rule in *Clayton's Case*. The background of legal rights and remedies necessary to understand arguments for and against the use of the rule in *Clayton's Case* is discussed in Chapter II. In Chapter III we examine the context in which the rule was first developed, and then follow its development in the law of trusts. Recommendations for reform are considered in Chapter IV.

B. The Working Paper

This Report was preceded by Working Paper No. 36, Competing Rights to Mingled Property: Tracing and the Rule in *Clayton's Case*. That Working Paper was circulated among members of the bar and of the judiciary, as well as professors of law and people with experience in the administration of insolvencies. A number of thoughtful and helpful responses were received and these will be referred to from time to time in this Report.

CHAPTER II RIGHTS AND REMEDIES

A. Introduction

Law is an ordered system of rights and obligations. It may include such things as privileges which flow from citizenship: examples are the right to vote, freedom of speech and freedom of religion. It may include rights to property: ownership of land or a car. Rights and obligations may arise by operation of law or they may be created consensually. An example of a consensual right is one that arises by contract. Every purchase from a retail store is a contract under which the buyer and the storekeeper agree that, upon payment of a certain amount of money, the storekeeper will transfer ownership or legal title to selected goods to the buyer.

B. Law and Equity

Before discussing in more detail the kinds of rights recognized by the law, it is important to define several terms. These terms are "common law," "law" and "equity."

The meaning of "common law" shifts depending on its context. It is always used in opposition to another concept. It may mean law which is based upon popular custom as opposed to law created by legislation. It may mean law based upon binding precedents as opposed to law in civil jurisdictions which is based upon principles unaltered by the cases in which they are applied. It may mean law which is based

upon popular custom as opposed to law developed by the English Courts of Chancery. Law developed by the Courts of Chancery is known as "equity." "Law" has the same meanings as "common law."

In this Report the terms "common law" or "law" will have one of two meanings. Which meaning is intended should always be clear from the context. We will use the terms "common law" or "law" to mean that law of British Columbia which is based upon precedent and originated in local custom, as distinct from law
created by statute. In that sense the terms "common law" and "law" also include equity. The terms "common law" and "law" will also be used in opposition to the term "equity" to denote legal principles developed by the old courts of common law as distinct from those principles developed by the Courts of Chancery. Initially this may appear confusing. Discussion of the distinctions between "law" and "equity" may clear up some of this confusion.

In the middle ages the English courts of common law, which developed and applied principles derived from local custom, had reached a point of rigidity. Sometimes the common law was inappropriate to contemporary needs. Sometimes the common law would not provide adequate redress.When the common law failed to provide an adequate remedy, the King, and later his Chancellor, heard petitions from aggrieved litigants for extraordinary relief. From this practice grew the Court of Chancery. That court granted remedies which the common law was unable to provide. It also provided relief, in some cases, from the harsh judgments of the common law courts. The law administered by the Courts of Chancery was called "equity." In time the rules applied by those Courts became as rigid as the common law they were intended to supplement.

In England, until 1875, these two separate bodies of law were administered by separate courts. It was important for a litigant to bring his case in the proper court. When a case arose that was governed by both the common law and by equity, equity prevailed.

The English *Judicature Act, 1873*, abolished the courts of common law and of Chancery, and set up a single court empowered to administer both law and equity. The British Columbia Supreme Court has always administered both law and equity. This is because when our judicial system was established we only had one judge, Matthew Baillie Begbie. Notwithstanding the fusion of the courts which administer law and equity, these two systems of law have never fused. Equitable remedies are not available to all litigants and special subsidiary rules apply to equitable principles which do not apply to common law principles.

C. Rights

Generally there are three kinds of rights. These are:

1. Real rights.
2. Possessory rights.
3. Personal rights.

The discussion of rights in this section, and of remedies in the next section, is intentionally simplified for our nonspecialist readers. Some understanding of these concepts is necessary for the purposes of this Report, but a detailed discussion would neither advance nor hinder the case for reform of the rule in *Clayton's Case*.

1. Real Rights

Real rights are rights which flow from ownership of real or personal property. These may permit a person the return of property which he owns. Traditionally, these rights are referred to as "rights *in*

rem." It is more convenient, since they depend upon the claimant having some interest in property, to refer to them as "proprietary rights."

The common law recognized only one kind of ownership of property, which was legal title to the property. Equity recognized that, notwithstanding legal title may lie in one person, other kinds of proprietary rights or interests, which ought to be protected, may be vested in another.For example, when a person mortgages his home, theoretically he conveys the legal title to the lender, the mortgagee. That "conveyance" is the mortgagee's security for repayment of money he has loaned pursuant to the mortgage. The property may, however, be worth $150,000 while the mortgage secures only $50,000. If the mortgagor defaults, it seems
unfair that the mortgagee could acquire property worth $150,000 for only $50,000. Equity recognized that the mortgagor retained an interest in his property, represented by the difference between its actual value and the value of the mortgage. Colloquially, that interest is referred to as the mortgagor's "equity" in the property. Technically, it is an "equitable proprietary interest" and it is the basis of the mortgagor's right to redeem the property within a reasonable time after defaulting on the mortgage (his "equity of redemption"). If that period (usually six months) expires, and the mortgagor has not paid off the mortgage, his equitable interest is "foreclosed" and legal and equitable title vest in the mortgagee.

The common law and equity, therefore, regarded property differently. In equity, ownership of each piece of real or personal property was regarded as consisting of two parts, legal title and an equitable or beneficial interest. In most cases a person who "owns" property will possess both legal title and the equitable interest in it. Sometimes, however, legal and equitable ownership is divided, as in the mortgage example.

2. Possessory Rights

Another kind of real or proprietary right is a possessory right. A possessory right is one which entitles a person to possession of real or personal property. A possessory right may flow from legal title to that property or may arise notwithstanding that someone else holds legal and equitable title to it. An example is a rented car. A person who owns a car enters into an agreement with another person to let him use the car for a price. If a third party takes the car, the law will protect the renter's possessory right to it. He will be entitled to its return. Additionally, these rights may entitle a person to damages for interference with property in his possession. That is the basis for such common law actions as trespass, nuisance and conversion.

This emphasis on possession, rather than ownership, is a legacy from an earlier time when wealth was primarily associated with tangibles and the law was preoccupied with repressing physical violence, combined with the persistent influence on legal thinking of the forms of action which developed out of these conditions. This explains the seeming paradox that a possessor without title, such as a finder, a bailee, a sheriff who has seized goods, and perhaps even a thief, may recover their full value; whereas an owner who has neither possession nor a right to immediate possession, like a bailor during an unexpired term, cannot compel the wrongdoer to buy him out. So great is the emphasis on protecting possession that even an owner may be guilty of conversion, as by dispossessing his bailee during the subsistence of a bailment not determinable at will.

3. Personal Rights

The last general category is comprised of personal rights. These are rights which may arise from, but do not necessarily depend upon, ownership or possession of property. They include rights which arise under contract or by law. For example, if A lends B money, A has a personal right to recover the amount loaned.

D. Remedies

While the framework of the law consists of these rights, its purpose is to protect them. There is very little point in having a right if the law will not protect it. The law provides two general kinds of remedies in support of proprietary, possessory and personal rights. These are real remedies and personal remedies.

1. Real Remedies

A real remedy is founded upon an existing real or proprietary right. A real remedy entitles the holder of a proprietary right to the return of his property. For example, if someone steals A's car, and it is found, the law will return it to A. Because a real remedy depends upon the claimant having some interest in property, and entitles the claimant to the return of the property, it is convenient to think of a real remedy as a "proprietary remedy."

2. Personal Remedies

A personal remedy entitles the holder of a personal, possessory or proprietary right to damages for interference with his rights. In general, common law personal remedies take the form of damages. Whether someone has a personal or proprietary right, ordinarily he will only be entitled to a personal remedy at common
law. Equity, which was developed to supplement the failings of the common law, deals in specific remedies. For example, if A contracted to sell land to B and then did not perform the contract, the common law would give B damages for A's breach of the contract. Equity, on the other hand, might compel A to perform the contract. That remedy is known as specific performance.

Equity will grant a proprietary remedy in favour of someone whose equitable proprietary rights have been interfered with. Additionally, if someone's personal rights have been interfered with, equity might grant a proprietary remedy.

This is a very general and simplified description of legal and equitable rights and remedies. It is essential to have some understanding of these principles to follow the discussion in this Report. One must remember that legal and equitable principles are the creation of hundreds of years of common law and statute.
It is understandable, therefore, that development of these principles has sometimes been haphazard, and that anomalies arise occasionally.

The subject of this Report is competing rights to mingled property. Priority between such competing rights is often determined by reference to the rule in *Clayton's Case*. That rule arises in the context of following or identifying money which at one time belonged to two or more people. Law and equity brought
very different principles to bear upon problems of identifying money.

E. Title to Property at Law

1. Property

Generally, title to property will not pass unless the seller has good title to give.
(i) in the market overt, or
(ii) from a seller who had voidable title if not voided at the time of sale, or
(iii) from a person in possession of the goods with the owner's consent, or
(iv) under any special common law or statutory power. If C steals A's car and then sells it to B, unless there arises some statutory exception necessary for the protection of commerce, A should be entitled to the return of his car. The law will protect his proprietary interest. However, if C holds A's car as trustee and sells it to B in breach of trust, the common law is helpless. C has the ability to convey legal title to B.

Equity, however, would recognize A's beneficial or equitable interest in the car. A could pursue personal rights and remedies against C for breach of trust. Alternatively, if the money paid by B to C can be found, A could assert a proprietary right to that money. However, A could not assert his beneficial title against B to secure the return of his car if B has bought it in good faith and for value.

2. Money

Commerce depends upon a freely negotiable medium of exchange. It is impractical to require recipients to investigate the true title to currency. For that reason an exception to the principle that title to property will not pass unless the seller has good title to give is made for currency.

Legal title to money passes to one who receives it in good faith and for value. If C steals A's money and makes a gift of it to B, A should be entitled to its return. B did not give value for it and therefore title to it did not pass to him. If C steals A's money and with it purchases a car from B, a curious situation arises. Title to currency passes to B, title to the car vests in C. A has no legal proprietary interest to protect. The
law, however, will still recognize A's right to a remedy against C. It is difficult to explain how the law is able to give A a remedy in this case. Various explanations regarding how the law provides a proprietary remedy to a claimant who no longer has a legal proprietary interest have been put forward. The means by which a remedy is made available is known as tracing or following property.

F. Tracing and Following Property

For the purposes of this Report we need not delve too deeply into the intricacies of tracing or following property. Nevertheless, some discussion is necessary.

Many examples we have used so far involve the transformation of one kind of property into another. Money, for example, is used to purchase a car, or it is deposited in a bank to create a credit in favour of the depositor. Any examination of proprietary rights must face the problem that arises when property is transformed into some other kind of property.

Suppose money belonging to A is used by B to purchase other property, say a car, from C. A was entitled to a proprietary remedy for the return of his money when it was in B's hands. As we have mentioned, however, it is necessary for commerce to have an easily negotiable form of currency. Title to money passes to one who receives it for valuable consideration without notice. C exchanged his car for A's money. C has title to the money. A has no proprietary remedy against C. Can A look to the car purchased by B? In a sense the car represents A's money.

Classic *dicta* with respect to this issue is to be found in the case of *Taylor* v. *Plumer*:

> It makes no difference in reason or law into what other form, different from the original, the change may have been made ... for the product of or substitute for the original still follows the nature of the thing itself, as long as it can be ascertained to be such, and the right [to follow and recover property in specie] only ceases when the means of ascertainment fail ...

This principle, that a claimant who has a proprietary interest in certain property may look to that property's substitute, is generally referred to as "tracing." Sometimes a distinction is made depending on whether the claimant asserts an equitable or a legal right. When asserting legal proprietary rights to the substitute for the original property the claimant is said to "follow" the property. When asserting equitable proprietary rights to the substitute for the original property the claimant is said to "trace." It is convenient to think of tracing or following as a means whereby the law has expanded the definition of what is the claimant's property.

Many technical difficulties arise from this expanded definition of what is the claimant's property. For example, if a claimant, A, has legal title to property which is exchanged by B for other property, legal title to the substitute property vests in B. A, because he had legal title to the original property, may not seek equitable remedies. He is confined to available legal remedies. The common law, however, with respect to proprietary

remedies, protected only legal title or legal possessory rights to property. In the example, legal title to the substitute property has vested in B.

While the law would grant to A a proprietary remedy for the return of the substituted property in specie, no reasonable explanation is available in traditional terms why it was able to do so. The only interest A could have in the property was equitable, and the law would not recognize an equitable interest.

Many attempts have been made to explain the workings of the right to follow at law in order to avoid the conclusion that the common law honoured some concept of equitable or beneficial interest in property. It has been explained that A's right to follow the substitute property depended upon his ability to ratify the wrongdoer's act. The law inferred a relationship between A and the wrongdoer akin to agency. Another explanation is that if the wrongdoer either does not give value or has notice of A's interest, then he is under a duty to account or he has attorned to A's rights. Another explanation is that under certain circumstances the law will presume the wrongdoer to have appropriated the chattel to A's use, either actually or notionally. All of these explanations depend upon fictions, and each one attempts to explain following by slotting it into some other aspect of the law to which it is similar.

An accurate explanation for following at law was not available until recently. In the past 30 years Canadian courts have come to recognize an area of law known as restitution or the law of unjust enrichment. The Supreme Court of Canada has explained the basic concepts of restitution. They are an enrichment or benefit to one party (in the example, the wrongdoer), a corresponding detriment to another party (in the example, A) and no juristic reason for the enrichment (that is, for allowing the benefit to remain where it is). If these criteria are met, the law will provide a remedy.

This approach to the problem avoids the misconception underlying the explanations for the right to follow at law discussed earlier. That misconception is that the existence of legal title is essential to the working of the common law right to follow. Possession, even without title, is protected against wrongful appropriation, whether the plaintiff chooses to sue in trespass or conversion. A possessor of goods has a good title as against every stranger, and one who takes them from him cannot defend himself by showing that the true title lies in some third person: he cannot, in the technical idiom, plead the *jus tertii*. This principle stems from the mediaeval axiom that the possessor is prima facie owner, impregnable save against one who can show a better right or who had the true owner's authority for committing the act or defending the action on his behalf.

> In contrast, a plaintiff out of possession and relying merely on a right to immediate possession must recover on the strength of his own title and come prepared to meet the defence of *jus tertii*. This principle, which emerged contemporaneously with a similar refinement in the action of ejectment, brought into prominence the proprietary, at the expense of the older delictual aspect of trover whose chief function henceforth became the trial of *title* to personal property.
>
> In many cases, legal title can only be proved by physical possession; often other evidence, such as documentary title, is not available. English law has never had any theory of ownership: *see* Vaines, *Personal Property* (5th ed., 1973), 39, 45:
>
> > ... [O]wnership of a material thing is nothing more than a figurative substitute for the ownership of a particular kind of right in respect of that thing; ... so soon as we attempt to treat it as anything more than a figure of speech, it becomes a fertile source of confusion of thought.
>
> Ownership is, of course, distinct from possession, although the distinction was, and still is, not always apparent. Ownership and possession were, according to Sir William Holdsworth, introduced into the common law as essentially different ideas through the workings of the action of ejectment in the case of land and trover in the case of chattels; and we are now wiser than our ancestors who "simply couldn't understand owning anything one does not actually possess. ('Give me the handle of the church door says the grantee of an advowson.')" But in many instances ownership still coalesces with possession for ... reasons, all of which flow from the principle that possession is prima facie proof of ownership.
>
> *See also* Salmond, Jurisprudence (8th ed.), 279.

As to the requirement that the claimant must claim as owner, *see: Harris* v. *Truman*, (1881) 7 Q.B.D. 340, *aff'd*. (1882) 9 Q.B.D. 264 (C.A.); *Sinclair* v. *Brougham*, [1914] A.C. 398; *Re Christie Grant Ltd.; Ex parte Canadian Express Co.*, [1923] 1 D.L.R. 505 (Man. C.A.); *Re Algo Sunderland Ltd.*, (1962) 3 C.B.R. (N.S.) 245 (Ont. S.C.); *Re Craftsmen Painting Contractors Ltd.*, (1967) 67 D.L.R. (2d) 37 (Ont. H.C.); *Re Stenning*, [1895] 2 Ch. 433; *Western Trust Co. and Wah Sing* v. *Wah Sing and Moose Jaw Securities Ltd.*, (1920) 56 D.L.R. 584 (Sask. C.A.); *Re Wayne Coal Co. Ltd.; Schultz's Case*, (1920) 55 D.L.R. 327 (Alta. S.C.); *Salter and Arnold Ltd.* v. *Dominion Bank*, [1923] 3 W.W.R. 257 (Man.K.B.); *Re Motor Sales Co. Ltd.*, (1923) 4 C.B.R. 63 (S.C.N.S.); *Re Niagara Peninsula Music Co.*, (1929) 11 C.B.R. 66 (Ont. S.C.); *Re Coville Transport Co. Ltd.*, (1947) 28 C.B.R. 262 (Ont. S.C.); *Re Frederick McLeod*, (1949) 29 C.B.R. 163 (Ont. S.C.); *Re Ballantyne Business Printers Ltd.*, [1951] 3 D.L.R. 329 (Ont. C.A.); *Re McIntoshMarshall Equipment Ltd.*, (1968) 68 D.L.R.(2d) 673 (Alta. S.C.A.D.). Although clearly a fiction is employed with regard to the product or substitute of the original property; *see Miller* v. *Race, supra*, n. 10; *Taylor* v. *Plumer, supra*, n. 15; *Banque Belge pour l'Etranger* v. *Hambrouck*, [1921] 1 K.B. 321 (C.A.); *Re Diplock*'s *Estate*, [1947] 1 All E.R. 522, [1947] Ch. 716, *aff'd*. on this point [1948] 2 All E.R. 318, [1948] Ch. 465 (C.A.); *aff'd*. (without consideration for claim in rem) *sub nom Min. of Health* v. *Simpson*, [1950] 2 All E.R. 1137, [1951] A.C. 251 (H.L.). The reason legal title in the defendant may constitute a defence is the result of policy to protect commercial transactions and the negotiability of currency. If the circumstances of the case do not bring this policy into issue, then it will not be invoked to protect the defendant. The courts will require the defendant to recognize his obligation to return the property or its substitute when it may not be retained in good conscience, regardless of where legal title may lie.

Equity's recognition of an interest in property avoided these theoretical or technical problems. Equitable proprietary remedies, however, are available only to one who has been deprived of his property by his fiduciary. The difficulty the law has protecting proprietary interests is an argument in favour of abolishing that need for a fiduciary relationship.

The advantage of tracing property in order to found a proprietary remedy is clearest when the item sought is rare or unusual, or the defendant is insolvent. If the defendant is insolvent, a claimant can achieve priority over other creditors of the insolvent, both general and secured, merely by establishing that certain property in the bankrupt's estate is the claimant's own. If the claimant is entitled to a personal remedy only, that is, damages, his claim ranks behind secured creditors and equally with general creditors. In the usual course of bankruptcy, general creditors receive a very small portion, if any, of monies owed them.

Before discussing how equity regarded money, it is necessary to observe that there are two limitations on exercising proprietary remedies at law. The first is that a proprietary remedy is not available when the relationship between claimant and defendant is that of debtor and creditor. The second is that the law is unable to trace or follow money into a mixed fund such as a bank account.

G. Debt

In the examples given in the previous section, money was conveyed to another and in certain cases a claimant retained a legal or equitable interest in that money. Because money is readily negotiable, seldom will it be identifiable after one or two transactions. Currency may be marked by serial numbers, but in the usual course of business serial numbers are not recorded. If a dollar bill is mixed with other dollar bills, usually it will be indistinguishable from the others. Essential to the nature of a proprietary remedy is the ability to identify particular property as one's own. If A loans B his car, A still retains property in it and is entitled to its return. In all likelihood, should the question arise, A will be able to identify his car from other like cars so that a proprietary remedy will not fail.

If A loans B money, he can never expect the return of the same bills or coins. He expects only repayment of the amount of money loaned. A advances credit to B. B becomes indebted for its repayment. A will never be entitled to a proprietary remedy for the return of that money. The law assumes that the parties intended title to pass. If B does not repay the money to A, A will be entitled to a personal remedy against B for repayment of a sum of money equal to that borrowed. That result is unsatisfactory if, for example, B is insolvent.

H. What is a Bank Account?

If A deposits money in a bank account, he does not expect to receive the identical currency when he makes a withdrawal. A bank account represents the idea of money, but really all that is created is a ledger of debt and credit. A's money is not kept separate. It is mixed with other funds.

For this reason the law was reluctant to follow A's money if it was stolen by B and placed in a bank account. The property had disappeared. Generally A was only entitled to a personal remedy against B. This result was not satisfactory to A if B was bankrupt, and the bank account was the only asset available to creditors. There is case authority to the effect that if no other money was mixed in the account, A's proprietary interest would be recognized notwithstanding that in reality the actual currency deposited could not be returned. If, however, other money was mixed with A's money in the account, there could be no proprietary remedy. The law could not conceive of how to divide mixed monies.

The rule in *Clayton's Case* is premised upon one model of banking: money comes out of an account in the order in which it is deposited, like water through a pipe; the first part of the stream to enter the pipe is presumably the first to exit. Equity, however, viewed mixture in a bank account differently.

I. Re Diplock

The great case of the 20th century on the issue of proprietary rights is *Re Diplock*. Caleb Diplock made a will in which he made several gifts to charities. Those gifts were held to be invalid, and Diplock's nextofkin tried to recover the money paid to those charities. The money had been used by the charities in various ways, including investment and the payment of debts. The money, therefore, had been mixed with other money, or been transformed into other kinds of property.

The treatment of mixed funds, at law and in equity, is contrasted in that case, *per* Lord Greene, M.R., as follows:

> The common law approached [the question of following money] in a strictly materialistic way. It could only appreciate what might almost be called the "physical" identity of one thing with another. It could treat a person's money as identifiable so long as it had not become mixed with other money. It could treat as identifiable with the money other kinds of property acquired by means of it, provided that there was no admixture of other money. It is noticeable that in this latter case the common law did not base itself on any known theory of tracing such as that adopted in equity. It proceeded on the basis that the unauthorized act of purchasing was one capable of ratification by the owner of the money ...
>
> It was the materialistic approach of the common law coupled with and encouraged by the limited range of remedies available to it that prevented the common law from identifying money in a mixed fund. Once the money of B became mixed with the money of A its identification in a physical sense became impossible; owing to the fact of mixture there could be no question of ratification of an unauthorized act; and the only remedy of B, if any, lay in a claim for damages.

Equity, however, was more flexible:

> Equity adopted a more metaphysical approach. It found no difficulty in regarding a composite fund as an amalgam constituted by the mixture of two or more funds each of which could be regarded as having, for certain purposes, a continued separate existence. Putting it in another way, equity regarded the amalgam as capable, in proper circumstances, of being resolved into its component parts.
>
> Adapting, for the sake of contrast, the phraseology which we have used in relation to the common law, it was the metaphysical approach of equity coupled with and encouraged by the farreaching remedy of a declaration of charge that enabled equity to identify money in a mixed fund. Equity, so to speak, is able to draw up a balance sheet on the righthand side of which appears the composite fund and on its lefthand side the two or more funds of which it is to be deemed to be made up.

Lord Greene, M.R., took great care to explain what questions were actually involved. The claimants sought to trace "money," but not "money" in the sense of physical currency. What follows is an "equitable" view of banking practice:

> To turn to another preliminary matter: We do not think that confusion can be avoided unless the meaning of the word "money" as used in connexion with this class of question is kept in mind. It is tempting to use the illustration of sovereigns in a bag or, to use an expression of Lord Dunedin's, a strong box. But this must not blind us to the fact that such an illustration has little or no likeness to actual facts in presentday conditions. We can explain what we mean by a reference to the present cases. The plaintiffs claim that "money" forming part of the residuary estate of the testator and, therefore, divisible among his nextofkin, has been improperly paid to a charity. This "money" when "paid" was in the form of a cheque on the executorship account, i.e., a negotiable instrument ...
>
> The charity accepted the cheque; and on the assumption that it was not a purchaser for value and is not to be charged with such notice as to make it a constructive trustee, it accepted the cheque as a volunteer. The first stage, therefore, was that the charity had in its possession a negotiable instrument which in origin belonged to the residuary estate and in which the nextofkin were, in the eyes of equity, interested.

> If the nextofkin had been in a position to interfere at that stage they could, in our view, clearly (and the contrary was not argued) have recovered the cheque from the charity whom, as a volunteer, equity would have compelled to recognize the equitable interest of the nextofkin in it. But the cheque was in fact paid into a banking account in the name of the charity. The nextofkin claim to follow their "money." What really happened was that when the cheque was cleared, a credit was passed by the paying bank to the collecting bank for the benefit of the charity who thus, without handling any "money" in the sense of cash, became possessed of "money" in the sense of credit in its banking account, i.e., a chose in action. Now if the "money" in the form of the cheque was "paid in" to a separate account so that the "money" in the form of a chose in action which resulted from the operation remained "unmixed" (i.e., was identifiable as a chose in action having a separate existence) it is not disputed that the "money" will be specifically recoverable from the charity. It is not suggested in that case that the title to the "money" of the charity as a volunteer can defeat the claim of the nextofkin to recover it for the benefit of the estate. The appropriate equitable relief would be by way of specific order for restoration of what, in the eye of equity, never ceased to belong in equity to the estate; the reason, of course, being that the charity, which took the cheque not as a purchaser for value without notice but merely as a volunteer, could not set up a title adverse to the estate in respect of "money" (i.e., on those facts a separate and identifiable chose in action) obtained by means of "money" in the form of a cheque, i.e., an order by the executors on their bankers to transfer "money" belonging to the estate in the form of a chose in action an aliquot sum of "money" in the form of a credit in favour of the charity, as payee of the cheque, in its account with its bankers.

In *Re Diplock* it was held that to assert a proprietary right in equity a claimant must establish a fiduciary relationship between himself and the defendant or between himself and another through whose hands the property has previously passed causing some equitable proprietary interest to attach to the property. It is that interest which the claimant traces by means of a constructive trust, equitable lien or charge.

In short, equity will protect A's beneficial interest only if legal and equitable title is divided. If C, a trustee for A, uses A's money to buy a car from B, equity will give A a remedy against C because C receives the car subject to A's equitable interest. Title to the money passes to B who gave value for it. A's equitable interest in money, or any other property, does not persist when it is transferred to a bona fide purchaser for value. One factor which determines whether the purchase was bona fide is whether the purchaser has notice of the beneficiary's equitable interest in the property. If, at the time of purchase, the purchaser has notice of that interest, he holds the property subject to it.

The most frequent explanation for requiring a fiduciary relationship to found an equitable proprietary remedy is that equity, prior to the *Judicature Acts*, could not exercise jurisdiction in the absence of such a relationship. That explanation is not wholly convincing. While the common law did not recognize beneficial interests, equity did recognize legal title, and a legal owner was no less an owner in equity. Nevertheless,
the requirement of a fiduciary relationship resulted in the courts of equity granting an equitable proprietary remedy to one who possessed a beneficial interest alone while denying such a remedy to one who possessed legal title.

J. What is a Fiduciary?

We observed that equitable remedies are only available to a claimant who has been deprived of his property by a trustee or a fiduciary. We neglected, however, to define "fiduciary," partly because that concept "has never been successfully defined or analysed."

Black's Law Dictionary offers the following insight into what is meant by the term "fiduciary:"

> The term is derived from the Roman law, and means (as a noun) a person holding the character of trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires ... As an adjective it means of the nature of a trust; having the characteristics of a trust; analogous to a trust; relating to or founded upon a trust or confidence.

This definition is not particularly helpful. It boils down to a statement that a fiduciary is one who owes trusteelike duties to another, but who is not necessarily a trustee. The definition is descriptive. It tells us what a fiduciary is. It does not tell us who is a fiduciary.

K. Who is a Fiduciary?

Another way of asking this question is: when does a fiduciary relationship arise? Professor Waters makes the following observations:

> A fiduciary relationship arises in equity whenever one person places trust and confidence in another. The occasion for this trust and confidence may be that X permits his property to be in Y's hands for some particular purpose, or that X places Y in an office which he is to discharge for X such as the performance of a particular task. Now it is obvious that the express trustee is a fiduciary visavis the beneficiary, but Equity is also prepared to find a fiduciary relationship between principals and agents, bailors and bailees, or any persons whose relationship may not readily be capable of categorization at law, but whose position is analogous to those described.

The reason why it is difficult, if not impossible, to state whether, in any given case, a fiduciary relationship exists is as follows: in many cases people who are not trustees may occupy positions of confidence with respect to another which give them power over that person, or provide them with rare opportunities to profit at that person's expense. It seems reasonable to make a person who exercises trusteelike powers subject to trusteelike responsibilities. When a fiduciary relationship arises, it may be due to the characterstics of the
parties involved. But fiduciary duties tend to arise from the circumstances of the case and may not be dependent on the personal attributes, characteristics or capacities of the parties themselves. A solicitor may owe some fiduciary duties to his client. These duties arise not because the solicitor is a solicitor, but because of his experience, or knowledge, or the activities he undertakes on behalf of his client. It is quite possible for two people to be in a fiduciary relationship with respect to one isolated matter, while in the remainder of their
dealings no such relationship arises.

An issue which was unresolved until the decision of *Re Hallett's Estate* in 1880 was whether equitable remedies available to a beneficiary against his trustee, were available to a person against his fiduciary. Jessel, M.R., denied that equity made any distinction between trustees and fiduciaries in this regard:

> Has it ever been suggested, until very recently, that there is any distinction between an express trustee, or an agent, or a bailee, or a collector of rents, or anybody else in a fiduciary position? I have never heard, until quite recently, such a distinction suggested. It cannot, as far as I am aware (and since this Court sat last to hear this case, I have taken the trouble to look for authority), be found in any reported case even suggested, except in the recent decision of Mr. Justice *Fry*, to which I shall draw attention presently. It can have no foundation in principle, because the beneficial ownership is the same, wherever the legal ownership may be. If you have goods bargained and sold to a man upon trust to sell and hand over the net proceeds to another, that other is the beneficial owner; but if instead of being bargained and sold, so as to vest the legal ownership in the trustee, they are deposited with him to sell as agent, so that the legal ownership remains in the beneficial owner, can it be supposed, in a Court of Equity, that the rights of the beneficial owner are different, he being entire beneficial owner in both cases? I say on principle it is impossible to imagine there can be any difference. In practice we know there is no difference, because the moment you get into a Court of Equity, where a principal can sue an agent as well as a *cestui que trust* can sue a trustee, no such distinction was ever suggested, as far as I am aware. Therefore, the moment you establish the fiduciary relation, the modern rules of Equity, as regards following trust money, apply.

It is certainly open to question whether the formulation of Jessel, M.R., was intended to restrict equitable remedies to trustees and fiduciaries. Nevertheless, subsequent cases have held that a fiduciary relationship is necessary before a claimant may claim an equitable proprietary remedy. The result is that one who possesses both legal and equitable title to property is not entitled to an equitable remedy against, for example, a thief who steals it.

The need for a fiduciary relationship has been criticized on numerous occasions. In the United States, that requirement has been abandoned. In England and Canada, the courts have, from time to time, stretched to characterize relationships as fiduciary, in order to avoid injustice. The courts' willingness to

find, as one commentator puts it, "ad hoc fiduciary relationships," or, as another has said, "fiduciaries to order," is basically destructive. Flexible definitions of "fiduciary relationship" make the law pertaining to fiduciaries and to proprietary remedies less certain. In some cases the offence itself is all that supports the finding of fiduciary duties. As Professor Waters has observed:

> ... when the law recognizes that the offence itself may give rise to the aspect of fiduciary relationship that is breached by the offence, we are not far from conceding finally that there is no logical distinction between the passing of property as a result of mistake or because of fraud, and the loss of it by theft.

The weight of judicial authority requiring a fiduciary relationship before equitable proprietary remedies are available makes it unlikely that the law, without benefit of reform legislation, will jettison that requirement. While it persists, anomalies abound. If B, A's fiduciary, pays A's money by mistake to C, or if C steals A's money from B, A may recover it in equity. But if A pays money by mistake to C, or if C steals A's money, A
may not recover it in equity. These are the results which flow from the requirement of a fiduciary relationship. That some courts have managed to overcome that requirement merely contributes to the disarray of the law in this area.

L. Mixture of Personal Property, Other Than Money, At Law

The law's treatment of money is unique and is explicable only generally in terms of the needs of commerce. If personal property other than money was mixed, and if the act of mixing was innocent, the parties were regarded as owning the property as tenantsincommon, the interest of each determined by the ratio of his property to the amalgam. If the act of mixing was wrongful, the innocent party took total ownership subject to the wrongdoer's right to identify his own property.

M. Money in Equity

While the law would not apply these principles to currency, equity would, provided the claimant possessed a beneficial interest in the property. As Atkin, L.J., observed, "If in 1875 the common law halted outside the banker's door, by 1879 equity had had the courage to lift the latch, walk in and examine the books." By use of an equitable lien or charge, or a constructive trust, equity could secure the claimant's interest in monies which had been mixed. A lien, charge or constructive trust would not fix upon the claimant's original property, but upon an amount or portion equivalent to that property.

Notwithstanding equity's enlightened views respecting tracing money into a mixed fund, it did not carry the right as far as it might have. Equity felt uncomfortable at being unable to point generally to the claimant's property and it seized upon a fiction developed in the context of banking with which to determine whether the claimant's property still remained in the fund. That fiction is the rule in *Clayton's Case*. It is strange that this
rule, which was premised upon the common law's "materialistic" view of money with respect to revolving credit arrangements, is only applied in equity to resolve questions of proprietary rights. Equity viewed mixture of money in a totally different fashion from the common law. The rule is not used when only common law proprietary remedies are available to a claimant, because a common law proprietary remedy is unavailable once money has been mixed.

CHAPTER III THE RULE IN CLAYTON'S CASE

A. Appropriation of Payments

A debtor may owe several distinct debts to his creditor. He may direct the application of any payment he makes toward satisfaction of those debts. Provided payment is not governed by contrary agreement, the creditor must apply the money in the manner directed by the debtor. If the debtor does not specify how the
payment is to be applied, the creditor is entitled to appropriate the payment to the debts as he may choose. Any appropriation by debtor or creditor must be communicated to the other. The debtor's right to appropriate the payment ends after making the payment. The creditor's right persists until it would be inequitable for him to exercise it. This was the legal background to a novel issue which arose with respect to appropriating deposits and withdrawals in an active bank account.

B. *Clayton's Case*: Appropriating Deposits and Withdrawals to Determine Rights and Liabilities Between a Creditor and a Debtor

Devaynes, a partner in a banking house, died in 1809. His death severed his partnership with other members of the banking house. His four former copartners, however, never changed their firm's name. They continued the business until their bankruptcy in 1810. An issue arose respecting the liability of Devaynes' estate for debts incurred by the banking house and owing at the time of his death. The circumstances of the case could be characterized in either of the following ways:

1. Upon Devaynes' death a new account with the new partnership began, and Devaynes' estate was jointly liable with the members of the former partnership for the balance in the accounts held by the old partnership up to Devaynes' death; or

2. Notwithstanding the change in entities (i.e., the severance of the old partnership and creation of the new partnership) the account was one unbroken account. If that was the case the question arose as to the order in which withdrawals offset the indebtedness of the old and of the new partnership to their depositors.

Several classes of creditors were identified and representative cases for each class were tried.

Clayton, a solicitor whose partnership acted on behalf of Devaynes' personal representatives, had a balance of £1,713 in his cash account with the banking house at the time of Devayne's death. Following Devaynes' death, Clayton continued to use his account. At the time of the banking house's bankruptcy, his balance exceeded that due at Devaynes' death. His minimum balance, following Devaynes' death, was £453.

In *Sleech's Case*, another action commenced on behalf of a class of the banking house's depositors, it had been held that each depositor was entitled to claim against Devaynes' estate no more than their lowest balance following Devaynes' death. Subsequent deposits were notionally placed in a new account for which only the surviving partners were indebted. With respect to withdrawals, however, it was assumed that the change in the partnership did not affect the fact that the transactions were on one unbroken account.

The issue to be resolved was whether Clayton's withdrawals must be credited against the deposit existing at Devaynes' death, in which case that balance had been paid off, or whether they could be credited against subsequent deposits, in which case Devaynes' estate was still liable for the minimum balance in Clayton's account following Devaynes' death. As we mentioned, at common law, a payor, indebted on separate accounts, could elect to credit payments as he chose. If he declined to make an election, the payee could credit the payment as he chose. If neither made an election, in certain cases it could be presumed that the payment was to be allotted in a particular way. For example, if ignoring one debt would incur bankruptcy while letting
another go unpaid would not, the courts would presume that payment had been made towards the debt which would prevent bankruptcy.

The court in *Clayton's Case* was faced with the question of how to appropriate withdrawals and deposits in the case of an active banking account, where all sums paid in formed one blended fund. *Clayton's Case* was a decision of first impression. Previous cases had always concerned election between two or more separate debts owed by a debtor to a creditor.

Banking, analytically, creates a debtorcreditor relationship. One who makes a deposit in a bank account becomes a creditor of the bank in that amount. The court, therefore, applied principles developed with respect to separate debts to banking practice in which a bank account represents a series of separate debts which have been indistinguishably blended. In the usual course there is no need to determine in what order the debt is discharged. A bank account represents only one sum which fluctuates with each deposit or withdrawal.

Sir William Grant, M.R., however, felt compelled to determine the order in which payments, at least notionally, are appropriated against debt in normal banking practice. He said:

> ... there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place, and are carried into the account. Presumably, it is the sum first paid in, that is first drawn out. It is the first item on the debit side of the account, that is discharged, or reduced, by the first item on the credit side. The appropriation is made by the very act of setting the two items against each other. Upon that principle, all accounts current are settled, and particularly cash accounts.

The court did not hold that "first in, first out" is invariably how a cash account was operated. It held that, from the circumstances, and in the absence of express appropriation by debtor or creditor, the parties in this case must be presumed to have intended that appropriation.

As a description of banking practice the presumption probably functions adequately, and, in the usual course, does little harm. Moreover, with respect to the limitation period for collecting a debt, it ensures that the oldest debts are paid off first. So, again, the Statute of Limitations has the same effect between banker and customer as between any other debtor and creditor. (Pott v. Clegg, 16 M. & W. 321; *Atkinson* v. *Bradford Third Equitable Building Society*, 25 Q.B.D. 377.) The customer's claim to a credit balance on current account left untouched for six years may be barred by the statute. (*Pott* v. *Clegg, ubi sup*.) And conversely the banker's claim to payment of an overdraft would be barred after six years if there had been no sufficient acknowledgement or payment of interest in the interval.

> Unless the account is absolutely dormant, the Statute of Limitations is, however, generally excluded by the system of appropriation of payments. In the absence of appropriation express or implied, the earlier drawings on an unbroken current account are attributed to the earlier payments in, in order of date. (*Clayton's Case*, 1 Merivale, 572, at p. 608.)

See also Snell's Principles of Equity (27th ed., 1973) 286. In that respect the rule is useful. It would be unjust if a debtor could secretly appropriate payments to debts most recently incurred in order that older debts became uncollectable when the limitation period expired.

Several things should be remembered in the balance of this Report. First, the "rule" in *Clayton's Case* is not a rule at all. It is a presumption, which the court made based on the circumstances of the case. It will not apply if either party expressly stipulates how payment is to be appropriated. Second, the presumption, at least in its inception, dealt only with offsetting debt with credit. It describes a model for understanding banking practice. But the common quality of all models is that they are facsimiles and are often very simplified forms of the reality they represent. Third, the presumption provides for the appropriation "intended" by the debtor or creditor. It is difficult to see how a presumption with respect to the intentions of debtors and creditors can apply when the interests involved are those of third parties, such as beneficiaries of the creditor who possess an equitable interest in the fund, or those entitled to a legal interest in the mixed fund. The applicability of *Clayton's Case* to third party interests is the question which concerns us in the next chapter. In the following discussion we examine developments in the law following the decision in *Clayton's Case*.

C. The "Rule" in *Clayton's Case*

The decision in *Clayton's Case* was not intended to set down a rule. The court inferred from the circumstances that the parties had tacitly agreed to apportion credit and debt by debiting withdrawals from deposits in the order in which they were made. Nevertheless, this model of banking practice with respect to an active cash account proved to be so convenient that it soon took on the status of a rebuttable presumption. In the early part of the 19th century, the "rule" was being applied unless rebutted by express intention of one or more of the parties. In *London & County Banking Co*. v. *Ratcliffe*, for example, a bank customer, Batten, granted an equitable mortgage to his bank to secure his past and future indebtedness to it. Batten had an active account with the bank. Batten sold the property. The bank, notwithstanding notice of the sale, continued to advance funds to Batten. The court held that the bank had a claim against the property sold to the purchaser only to the amount advanced up to the time of the sale. It further held, however, applying Clayton's Case, that Batten's deposits in his bank account must be credited first against the indebtedness secured by the equitable mortgage. Batten's deposits exceeded, and therefore extinguished, the sums secured by the equitable mortgage.

Although the use of a rule for determining appropriation of debt and credit is in many respects a convenient means of resolving priorities between a creditor and his debtor, the problem in *Clayton's Case* may have been viewed from a different perspective. Should a client (creditor) of a bank be able to look to a previous partner of the bank (debtor) after having continued extensive dealings with a newly constituted debtor on the same account? Quite apart from the legal principles involved, it seems unfair to permit a creditor to receive payments from one debtor on his own account, when that debtor is jointly liable with another debtor for an earlier debt. Certainly, it is in the creditor's best interests to appropriate payments in that way if the earlier debt is secured separately. It is an appropriation which must be made expressly, however, since the law will not make an inference that clearly prefers one party over another, when other inferences are more evenhanded.

A more reasonable presumption is that payments, since they had always been on behalf of all the joint debtors, continued to be on behalf of all the joint debtors, notwithstanding the severance of the partnership. In favour of this view, the courts can infer from the early payments an implied agreement between creditor and debtor, not as to the manner of appropriating specific credit to specific debt, but as to general liability with respect to that debt.Nevertheless, although the rule adopted in *Clayton's Case* was unnecessarily wide for the circumstances of the case, it did, on those facts, achieve a just result.

Following the development of *Clayton's Case* is difficult if only because of the mass of subsequent cases in which the rule is considered or applied. The cases of *Pemberto* v. *Oakes*, *Simson* v. *Cooke*, *Hooper* v. *Keay*, and *Laing* v. *Campbell*, concerned payments by a "new" partnership, arising after the death of a partner, on an unbroken account. In each case the court applied the rule in *Clayton's Case*. In *Brooke* v. *Enderby* the creditor's account was with A, who was, for a time, in secret partnership with B. That partnership was severed shortly before A's bankruptcy. The court applied the rule in *Clayton's Case* to discharge the partnership debt. The creditor could not look to B. Because in this case the partnership was secret, it is not possible to infer an agreement that all payments were to be applied on behalf of joint debtors, as could have been done in *Clayton's Case*. Nevertheless, one might argue that it is unfair for a creditor to
be able to look to a different asset base when he undertook to look only to A for repayment. With respect to inferring appropriation in the absence of specific directions, the law is unlikely to infer either that A allocated payments to his own account, or that the creditor received them to A's own account, since either inference prejudices B. In *Lysaght* v. *Walker*, for example, one finds a formulation of the rule, not in terms of offsetting debit with credit, but in terms of the interests of third parties:

> There are cases of running accounts kept as between partners, where, the interests of third persons being concerned, it has been held that a payment is to be considered as applicable to balances due, so as to discharge such third persons.

If appropriation is to work to B's disadvantage, one would expect that B should receive notice of that appropriation.

27. Where a principal debtor has made a payment to a creditor, or has otherwise performed all or part of an obligation due to a creditor, which payment or performance could have been applied to reduce or extinguish those obligations secured by a guarantee, the creditor should be required to apply the payment or performance to reduce or extinguish the obligation in respect of which the guarantee was given.

28. Where a principal debtor owes more than one debt to a creditor, each of which is secured by a guarantee, any payment or performance by the principal debtor must be applied to reduce or extinguish the debts in the order in which they were guaranteed. In *Brooke* v. *Enderby* it was unnecesary to use so wide a rule as that in *Clayton's Case*. It was, however, simpler than defining the precise principles involved.

In 1828, in the case of *Field* v. *Carr*, Best, C.J., cites *Bodenham* v. *Purchas* (in which it was said that the rule "seems most consistent with reason") to support the proposition that the rule can only be rebutted by express appropriation:

> It is undoubtedly open to the party to shew a payment on account of the particular bill...in the absence of proof of any such application of the sums paid in, the first payments must be applied to the discharge of the first debts.

In *Field* v. *Carr*, the defendant drew a bill of exchange in favour of A. A deposited it with his bank. The bill of exchange was dishonoured. The bank was a purchaser for value of the bill of exchange and entitled to go against the defendant for payment. It did not. The defendant paid the money to A. A subsequently deposited with his bank more than enough to cover the dishonoured bill, and for three years the bank treated the bill as paid. A became bankrupt and the bank proceeded against the defendant on the dishonoured bill. A majority of the court found that the rule in *Clayton's Case* applied and the debt evidenced by the bill was extinguished. One might wonder how payments by A would extinguish the defendant's debt. The result, nevertheless, was fair. *Clayton's Case*, however, need not have been applied. Gasalee, J., for example, found that the plaintiff's claim had been destroyed by its conduct. It was immaterial whether it had been paid by A or not.

The status of the rule is ambiguous throughout this period. In 1831, in the case of *Lysaght* v. *Walker* mentioned above, the rule was rebutted by inferences drawn from the circumstances of the case. An agent opened an account, in which he deposited money received from his principal. After setting up the account, subsequent deposits equalled subsequent withdrawals. The trial judge held that appropriation was a question of fact to be left to the jury. The jury found that payments must be appropriated against receipts by amount. Upon appeal, it was held that the judge was correct in leaving the question to the jury. The rule in *Clayton's Case* did not apply to extinguish the agent's debt to his principal based upon the initial deposit. The monies received from the principal to make that deposit had been secured by a guarantee. The guarantor was therefore still liable.

In *Re Taurine Co. Ltd*., the T Co. dealt with A until it was wound up in 1874. At that time T Co. owed A £1,070. A new company under the same name was formed. A was unaware of the winding up and continued to deal with the new company. The new company was wound up in 1875. If the rule did not apply, A could look to both companies for repayment. However, the rule was applied so that the first company's debt was extinguished. A fairer result might have been to treat the single account as two separate accounts, as was done in *Green* v. *Clarke*. Then, even if the rule did apply with respect to each account, it would not have
prejudiced A's claim against the first company.

Not until the latter part of the 19th century do we find the courts withdrawing from the rule. In *The "Mecca"*, for example, it was held that the rule was, at best, a presumption. It has been observed that:

> The rule (in *Clayton's Case*) in itself is sound enough. It is its application to cases never contemplated by Sir William Grant that is objectionable. And it seems to us that whenever there are intervening equities in favour of third parties, the true doctrine is, that the law will apply the payments according to its own notion of the intrinsic justice and equity of the case.

This Report concerns the objectionable application of the rule in *Clayton's Case* to a group of cases never contemplated by Sir William Grant: monies belonging to two or more people which have been mixed in a single account. Indeed, that group of cases may have provided the impetus in the latter part of the 19th century to move away from a strict presumption rebuttable only by express intention of one or other of the parties.

CHAPTER IV MIXED MONIES

So far our discussion has focused upon the rule in *Clayton's Case* as it applies between a creditor and his debtor. While occasionally unexpected results ensue from applying the rule, it is not possible to conclude that the rule should be changed in that context. Moreover, there has been no call for reform of the rule as it applies between, for example, a depositor and his bank.

This chapter concerns application of the rule when money of two or more people is mixed in a single fund, for example, in a bank account. Different issues arise depending on the relationship between the depositor and the persons whose money has been mixed. Whether the rule in *Clayton's Case* is applicable also depends upon what sort of relationships exist between the parties who assert competing claims to the mixed fund.

A. Nonfiduciaries

We discussed earlier the significance of a fiduciary relationship. Briefly, if one who deprives a person of property is not a fiduciary, equitable remedies are unavailable. The claimant must rely upon remedies provided at law. Suppose A steals B's money and mixes it with his own in an active banking account. Withdrawals are then made from the account. Does the rule in *Clayton's Case* apply? Actually, that is not the first question that must be resolved.

The question one must first ask is what sort of remedy does the common law provide. The plaintiff is entitled to the return of his money, but how does the common law effect its return? At one time the law did provide specific remedies. However, no remedy at law currently exists whereby a claimant may, as a matter
of right, require return of his property in specie, with the exceptions only of replevin if one stretches a point and reception. By these proceedings the owner might obtain both the restitution of the goods and the punishment of the thief; for if the owner succeeded in maintaining the charge of theft and the goods were worth twelvepence or more, the thief was condemned to death for the felony.
That action, because it required archaic and cumbersome procedure, was superseded by the action of trespass in the thirteenth century: *ibid*. 8. Conversion lies in damages; detinue has never been classified as a remedy in rem: *Phillips* v. *Jones*, (1850) 15 Q.B. 859, 867, 117 E.R. 683, 686; and whether property is recoverable in specie now depends on the discretion of the court, which is moved by considerations of whether damages are an inadequate remedy, as in the case where the chattel is rare or unusual: *Whiteley* v. *Hill*, [1918] 2 K.B. 808 (C.A.), or where the defendant is insolvent: *Dowling* v. *Betjemann*, (1862) 2 J.&H. 544, 70 E.R. 1175. Replevin, which became a statutory remedy, is an historically, procedurally and substantively odd remedy (see our *Report on The Replevin Act* (LRC 38, 1978); our recommendations have been implemented in recent amendments to the Supreme Court Rules: Rule 46, as revised by B.C. Reg. 467/81 and the repeal of the *Recovery of Goods Act*, R.S.B.C. 1979, c. 357, by S.B.C. 1982, c. 46, s. 37. Replevin offered prejudgment relief upon posting sufficient security for the return of property in which the plaintiff claimed a proprietary interest. It allowed something similar to specific performance in circumstances where specific performance would be unavailable under the *Sale of Goods Act*, R.S.B.C. 1979, c. 370, or in equity, since it was without regard to the specific nature of the goods nor to the duty to mitigate. Historically only available for goods taken by wrongful distress (Blackstone, vol. III, 145) by statute it applied to any chattel. Further, if the chattels were removed outside the jurisdiction, the plaintiff took another order of replevin, called an Order in Withernam, which permitted the sheriff to seize other property of the defendant to an equivalent amount, a procedure contrary to the ordinary principles governing prejudgment execution. The order was maintainable by one entitled to possession: *Employer's Liability Assurance Corp. Ltd.* v. *Metropolitan Toronto*, [1966] 2 O.R. 485 (Co. Ct.), regardless that he had no title against a third party: *Gilmour* v. *Buck*, (1874) 24 U.C.C.P. 187 (C.A.); *Penner* v. *Simpson*, [1941] 3 W.W.R.235 (Man. C.A.), or that title is equitable: *Carter* v. *Long and Bisby*,(1896) 26 S.C.R. 430, *MaDonald* v. *McPherson*, (1886) 12 S.C.R. 416. Recaption is the only common law remedy which can be termed an in specie remedy, *see, e.g., Taylor* v. *Plumer*, (1815) 3 M. & S. 562, 105 E.R. 721, and it may not be exercised if it will disturb the peace: *R.* v. *Doucette*, [1960] O.R. 407 (C.A.). It is interesting that replevin was first available only for wrongful distress because distress in itself is most odd: it is a means whereby a general creditor, a landlord, who possesses only a claim for debt for arrears of rent, may secure himself by seizing chattels belonging to his tenant; for a more detailed discussion of the law of distress *see our Report on Distress for Rent* (LRC 53, 1981). There is no particular reason why a landlord should be so preferred, and therefore the right has been removed by legislation in many jurisdictions where the tenancy is residential, and in commercial tenancies where the tenant becomes bankrupt (*Bankruptcy Act*, R.S.C. 1970, C. B3, s. 51(4)). The common law deals in damages (not in specific performance) and of the usual remedies invoked in support of proprietary rights conversion, detinue, trover, replevin, and money had and received none provides an absolute *in specie* remedy.

In the example, notwithstanding that A never acquired property in the stolen money, the bank, provided it was unaware the money was stolen, did acquire good title to it. Under the principles of the common law, B's only remedies are against A. A no longer has the money. A has, however, acquired a kind of an asset with B's money.

That asset is debt. The bank owes A a sum of money equal to that deposited with them. A therefore has a right to the payment of money exercisable against the bank. That right is called a chose in action. Jowitt defines a chose in action as "a right of proceeding in a court of law to procure the payment of money ... or to recover pecuniary damages for the infliction of a wrong or the nonperformance of a contract." A chose in action is not property in its ordinary or colloquial sense, such as real estate or a bicycle is property. Nevertheless it is regarded by the law as property, notwithstanding its intangible nature.If it is possible to identify a principal's money with an asset purchased exclusively by means of it we see no reason for drawing a distinction between a chose in action such as a banker's debt to his customer and any other asset. If the principal can ratify the acquisition of the one, we see no reason for supposing that he cannot ratify the acquisition of the other. Will the law recognize B's interest in that property?

In *Banque Belge pour L'Etranger* v. *Hambrouck*, H fraudulently obtained cheques drawn on the plaintiff bank in favour of his employer. He paid these cheques into his own account at another bank. No monies were mixed with the money belonging to his employer. He drew cheques upon that account in favour of his mistress, who did not give value for them and who deposited them into her own account with another bank. When the plaintiff commenced its action, that bank paid the money into court. A majority of the English Court of Appeal held that the plaintiff was entitled to the return of its money at common law in an action for
money had and received.

This case is difficult to understand. For a variety of technical reasons, the plaintiff should not have been entitled to the actual return of the money. No case since *Banque Belge pour L'Etranger* v. *Hambrouck* has gone so far. It is also evident that whatever proprietary right the plaintiffs may have had in equity to the debt owed by the third defendants to the second, no form of order known to the common law could have vested that debt in the plaintiffs.

It is convenient to think of this case as one where the money remained identifiable. If it was mixed, or its identity submerged in other property (i.e., debt), either the court felt sufficient evidence was available to locate it, or, by paying the money into court, an appropriation (or "unmixing") of the money was made. The problem of how the action for money had and received was used to recover specific money, for example, cannot be resolved. Nevertheless, in many respects, the case is instructive.

The limited nature of remedies available at law suggests that very seldom will a claimant who is deprived of money be able to secure its return. Usually he will only receive damages. If the defendant is insolvent, the plaintiff is unlikely to receive anything. For these reasons the question of whether *Clayton's Case* applies between a thief and one from whom he has stolen money never seems to have arisen. Similarly, if the issue was one of mixed stolen monies, the applicability of *Clayton's Case* would not arise.No remedy other than the selfhelp remedy of recaption is available at law for the return of money in specie. It is only when equitable remedies are available that the issue arises of whether *Clayton's Case* applies. Under the current law, equitable remedies for the return of money in specie are available only when a trustee or a fiduciary is involved.

B. Appropriating Withdrawals from a Fund Composed of Monies Deposited by a Trustee and His Beneficiary

In *Pennell* v. *Deffell*, Green, an official administrator, kept trust funds in his personal account. Upon his death, an issue arose between the official administrator who succeeded him and the heirs of Green's estate concerning entitlement to the bank account. The court recognized that, had the issue concerned mixed chattels
or mixed currency, the law would presume that chattels or currency removed by the trustee were his. A current account, however, was governed by the rule in *Clayton's Case*, so that withdrawals from the account were presumed to be made from monies in the order of their deposit. In this case, the first deposits were of trust monies, and therefore, the balance of trust monies was reduced by withdrawals. ViceChancellor Wood, in *Merriman* v. *Ward*, summarized the principle in *Pennell* v. *Deffell* as follows:

> The Lords Justices had to consider whether the doctrine of appropriation could be overruled by another principle, namely, that the assignee must be presumed, so far as possible, to have drawn against his own fund, because the opposite presumption would be a presumption of fraud. Nevertheless, the Court held that the ordinary rule must apply, of appropriating the earlier payments to the earlier debts.

Pennell v. *Deffell* was followed in *Brown* v. *Adams*, and in *Ex parte Cooke*. In 1879, it was overruled in *Re Hallett's Estate*. Jessel, M.R., took great pains to describe the principle that the *cestui que trust* of the money was entitled to a lien on the whole of the fund and to follow it into other forms and hands. The court's decision, however, was not based on that principle. It was based upon the proposition that the drawer is presumed to withdraw his own money in preference to the trust money:

> Now, first upon principle, nothing can be better settled, either in our own law, or, I suppose, the law of all civilised countries, than this, that where a man does an act which may be rightfully performed, he cannot say that that act was intentionally and in fact done wrongly. A man who has a right of entry cannot say he committed a trespass in entering. A man who sells the goods of another as agent for the owner cannot prevent the owner adopting the sale, and deny that he acted as agent for the owner. It runs throughout our law, and we are familiar with numerous instances in the law of real property. A man who grants a lease believing he has sufficient estate to grant it, although it turns out that he has not, but has a power which enables him to grant it, is not allowed to say he did not grant it under the power. Wherever it can be done rightfully, he is not allowed to say, against the person entitled to the property or the right, that he has done it wrongfully. That is the universal law.
>
> When we come to apply that principle to the case of a trustee who has blended trust moneys with his own, it seems to me perfectly plain that he cannot be heard to say that he took away the trust money when he had a right to take away his own money. The simplest case put is the mingling of trust moneys in a bag with money of the trustee's own. Suppose he has a hundred sovereigns in a bag, and he adds to them another hundred sovereigns of his own, so that they are commingled in such a way that they cannot be distinguished, and the next day he draws out for his own purposes £100, is it tolerable for anybody to allege that what he drew out was the first £100, the trust, and that he misappropriated it, and left his own £100 in the bag? It is obvious he must have taken away that which he had a right to take away, his own £100. What difference does it make if, instead of being in a bag, he deposits it with his banker, and then pays in other money of his own, and draws out some money for his own purposes? Could he say that he had actually drawn out anything but his own money? His money was there, and he had a right to draw it out, and why should the natural act of simply drawing out the money be attributed to anything except to his ownership of money which was at his bankers.

The court, therefore, relied upon another fiction (*Clayton's Case* is only a fiction) to resolve the issue.... it may be said that they [the Lord Justices who decided Pennell v. Deffell] had proceeded upon a misapprehension of the principle of Common Law applicable to the appropriation of payments in a banking or any other account. This may possibly be so, and if it was so, I am inclined to think that the misapprehension was shared by Sir William Grant, in laying down the rule in *Clayton's Case* ... As with *Clayton's Case*, it was a fiction which worked only in relation to the facts of the case before it. If, for example, the first money withdrawn by the trustee was invested wisely, and then the balance of the fund squandered, the presumption that the trustee withdrew his own money first would lead to serious injustice. That fact pattern occurred in *Re Oatway*.

Oatway, a solicitor and a trustee of estate funds, paid them into his own account. With funds drawn from that account, he purchased Oceana shares which he retained, and he applied the balance of the account to his own purposes. The court relied upon the first part of the holding in *Re Hallett's Estate*, that the beneficial owner of monies mixed with another's can trace them into property purchased with funds drawn from the mixture, based upon the principle that a beneficial owner is entitled to a charge on the fund or upon property purchased with monies drawn from that fund. Joyce, J., said:

> ... when the private money of the trustee and that which he held in a fiduciary capacity have been mixed in the same banking account, from which various payments have from time to time been made, then, in order to determine to whom any remaining balance or any investment that may have been paid for out of the account ought to be deemed to belong, the trustee must be debited with all the sums that have been withdrawn and applied to his own use so as to be no longer recoverable, and the trust money in like manner be debited with any sums taken out and duly invested in the names of the proper trustees. The order of priority in which the various withdrawals and investments may have been respectively made is wholly immaterial ...
>
> It was objected that the investment in the Oceana shares was made at a time when Oatway's own share of the balance to the credit of the account (if the whole had been then justly distributed) would have exceeded £2137, the price of the shares; that he was therefore entitled to withdraw that sum and might rightly apply it for his own purposes; and that consequently the shares should be held to belong to his estate. To this I answer that he never was entitled to withdraw the £2137 from the account, or, at all events, that he could not be entitled to take that sum from the account

> and hold it or the investment made therewith, free from the charge in favour of the trust, unless or until the trust money paid into the account had been first restored, and the trust fund reinstated by due investment of the money in the joint names of the proper trustees, which never was done.
>
> The investment by Oatway, in his own name, of the £2137 in Oceana shares no more got rid of the claim or charge of the trust upon the money so invested, than would have been the case if he had drawn a cheque for £2137 and simply placed and retained the amount in a drawer without further disposing of the money in any way. The proceeds of the Oceana shares must be held to belong to the trust funds under the will of which Oatway and Maxwell Skipper were the trustees.

Joyce, J., therefore, held that, as a general principle, the beneficiary was entitled to a charge against the fund or its product. *Clayton's Case* was inapplicable. It was not a matter of offsetting the "rule" in *Clayton's Case* with another presumption or "fiction." However, Joyce,J., was careful to restrict this principle to cases involving only "one fiduciary owner or set of *cestuis que trust*." The question of whether the rule in Clayton's Case would apply when the interests of several competing *cestuis que trust* were involved was still open.

In Canada and England, the formulation of Joyce, J. has never been truly accepted. The fiction adopted in *Re Hallett's Estate* is still in currency. The cases reveal that the courts still tend to approach the problem by presuming that the trustee spends his own money first, unless the presumption operates to the disadvantage of the beneficiary. It is submitted, with respect, that the usual explanations, that the presumptions are all against a trustee who mixes trust money with his own money, or that a trustee may not invoke his own wrong as a defence, are wrong. The correct formulation of the rule would appear to be that the claimant is entitled to a lien or charge on the mixed fund and any traceable property shown to be a product of the mixed fund. That this formulation is not accepted is clearly demonstrated by the position at law respecting the interests of several *cestuis que trust* in a mixed fund depleted by a trustee. Their interests are determined by applying the rule in *Clayton's Case*.

C. Appropriating Withdrawals from a Fund Composed of Monies of More Than One Beneficiary

If a trustee deposits trust funds belonging to one beneficiary into an account, mixing them with his own funds, we have seen that the rule in *Clayton's Case* does not apply. If the trust funds belong to more than one beneficiary, however, the rule applies.

In *Re Stenning*, a solicitor deposited a client's funds in an active bank account, in the amount of £448 18s. 6d. Subsequently the solicitor deposited money he held in a fiduciary character for several other clients. The solicitor died. His estate was insolvent. The monies in the bank account were paid into court to determine the respective interests and priorities of the *cestuis que trust* of the solicitor.

It was held that the money claimed by the first client was held by the solicitor as a loan and, therefore, she had no interest in the fund. The court also held, however, that even if the monies had been held in trust, the rule in *Clayton's Case* would apply so that the balance would consist only of those monies most recently paid in. The rule "determined" that all of her money was withdrawn.

If the case had been decided in terms of the first part of the decision in *Re Hallett's Estate*, the analysis might have gone as follows: as between trustee and beneficiary the rule in *Clayton's Case* does not apply. The beneficiary is entitled to a lien on the fund to the extent of his interest, or to the minimum balance in the account following the deposit of his money, whichever is less. Accordingly, the claimant whose money was first deposited was entitled to a lien on the fund, securing the amount of £488 18s. 6p., at the time other trust monies were deposited. Each of the beneficiaries of deposited money was entitled to a lien. Deprivations on that fund which followed would be shared equally, the lien of each cestui que trust fixing upon the proportional interest each had in the reducing fund. There was no need to apply *Clayton's Case*.

In *Hancock* v. *Smith*, trust monies from several beneficiaries had been paid into a common account. Notwithstanding various transactions, including withdrawals that in total exceeded the sum of trust monies, the balance never fell below the amount needed to satisfy all the claims of the *cestuis que trust* of the money. The trustee testified that none of his own monies had been placed in the account (the case does not explain to what purpose withdrawals were made, nor from what source subsequent deposits were drawn). A judgment creditor of the trustee obtained a garnishee order against the account. At trial it was held, applying the rule in *Clayton's Case*, withdrawals must be appropriated against the trust money in the order of their deposit. The monies remaining were not impressed with the trust. The monies were therefore payable to the judgment creditor pursuant to his garnishee order.

Upon appeal, it was held that, while the rule in *Clayton's Case* was applicable between several *cestuis que trust* (following the decision of Fry, J., the trial judge in *Re Hallett's Estate*, a point not overruled by the Court of Appeal) it did not apply when no question arose between the various *cestuis que trust* and there were sufficient funds to satisfy their claims in full:

> The question arises between them [the trustee's cestuis que trust] and a person who claims under a judgment against their trustee. Now an execution can only take effect on property which the debtor has a right to dispose of for his own purposes. The balance here in question was not the debtor's own money, he had no right to deal with it as his own, and his execution creditor has no claim upon it.

The rule in *Clayton's Case*, it was held, would apply between *cestuis que trust* only if there was not enough in the fund to satisfy their claims in full:

> The rule in *Clayton's Case* would apply as between the *cestuis que trust* if there was not enough to pay them all. Here there is no conflict between them, for the evidence shews that there is no client of the Defendant who can claim an interest except these four persons, and there is money in hand to pay them, so the rule in *Clayton's Case* does not apply. It was said that the money to be paid out is not the same money that was paid in, and that therefore the Claimants cannot follow it, but no one ever does receive out of a bank the same sovereigns that he paid in. If a trustee has money of his own mixed with trust money in the same account, all his drawings out for his own purposes must be attributed to his own money, and he cannot claim to apply the rule in *Clayton's Case* for his own benefit as against the *cestuis que trust*, nor can his execution creditor do so, and still less in a case where no money of the debtor's own has ever gone into the account.

D. Where the Money of a Beneficiary is Mixed with that of a Volunteer

A volunteer is a person who innocently receives money or other property as a gift. He gives no consideration for it. If a person who receives money or other property has notice of someone else's legal or equitable interest in that property, he is not an innocent volunteer. He is a constructive trustee and he holds the property for the benefit of the person who has a legal or equitable interest in it.

If B, A's trustee, gives the money he holds in trust for A to C, and C, without notice of A's interest, mixes that money with his own, is A entitled to a remedy against C? Is a volunteer in the same position as other claimants to a mixed fund?

In *Re Diplock*, it was clarified that a claimant's tracing right did not depend upon equity working on the conscience of the recipient of money. That is how the principle began, but from that beginning were created "what were in effect rights of property, though not recognized as such by the common law." With respect to a claimant and his trustee or fiduciary, the claimant's rights are paramount. He must be paid in full before his trustee or fiduciary may exercise rights of property. Since the right did not depend upon equity working on the conscience of the recipient of money, it should make no difference that an innocent volunteer received the money. With respect to other claimants, including innocent volunteers, the equities between them are equal and none should have priority over others. The following statements, based upon this principle, were made:

> From the foregoing study of Lord Parker's speech, it would appear that in his opinion there is an equitable principle common to all these cases of mixed funds. It operates in different ways according to the circumstances. In some

> cases it results in a priority to one or other of the claimants, in other cases the claimants rank pari passu. Where one claimant is a person in a fiduciary relationship to another and has mixed moneys of that other with moneys of his own, that other takes priority. The same result follows where a person taking that other claimant's money from the person in a fiduciary relationship, with notice that it is money held in a fiduciary capacity, proceeds to mix it with money of his own. Where the contest is between two claimants to a mixed fund made up entirely of moneys held on behalf of the two of them respectively and mixed together by the fiduciary agent, they share pari passu, each being innocent. Where the moneys are handed by way of transfer to a person who takes for value without notice, the claim of the owner of the moneys is extinguished just as all other equitable estates or interests are extinguished by a purchase for value without notice. In the case, however, of a volunteer who takes without notice, e.g., by way of gift from the fiduciary agent, if there is no question of mixing, he holds the money on behalf of the true owner whose equitable right to the money still persists as against him. On the other hand, if the volunteer mixes the money with money of his own, or receives it mixed from the fiduciary agent, he must admit the claim of the true owner, but is not precluded from setting up his own claim in respect of the moneys of his own which have been contributed to the mixed fund. The result is that they share pari passu. It would be inequitable for the volunteer to claim priority for the reason that he is a volunteer: it would be equally inequitable for the true owner of the money to claim priority over the volunteer for the reason that the volunteer is innocent and cannot be said to act unconscionably if he claims equal treatment for himself. The mutual recognition of one another's rights is what equity insists upon as a condition of giving relief.

From the foregoing analysis, one might expect the court to have found that, as between competing beneficiaries of a trust fund or as between a beneficiary and a volunteer who holds the trust monies, the rule in *Clayton's Case* would be inapplicable. It is necessary to consider two cases:

1. A trust fund which consists of monies of two or more beneficiaries, held by a trustee who uses some of the monies for his own purposes.

2. A trust fund which consists of the money of a beneficiary and of a volunteer who holds the money and uses it for his own purposes.

In the first case, application of the rule in *Clayton's Case* means that any shortfall will be borne by the beneficiaries whose money was deposited first in time. As between two or more beneficiaries, there is no reason why the shortfall should not be borne equally among them.

Similarly, in the second case, application of the rule in *Clayton's Case* means that any shortfall will be borne by either the volunteer or the beneficiary, depending on whose money was deposited first in time. Such a result is undesirable, first because the rule is arbitrary, and operates without reference to which one, between the two, should bear the shortfall. Second, in *Re Diplock*, it was held that the volunteer's interest in the mixed fund is given equality with that of the beneficiary. If the volunteer has received no benefit from the fund, there is no argument against granting rival claimants equality. It should make no difference whether the competition is between two beneficiaries of the fund, or a beneficiary and a volunteer. If, however, the volunteer has used the fund for his own purposes, so that any shortfall experienced by the fund is due to the volunteer's use of and benefit from that money, the beneficiary, merely because his money is deposited first in time, should not be required to bear the shortfall.

Money used by a volunteer should be deducted from his proportional share of the fund, regardless of the order in which money was deposited. If withdrawals exceed that sum, they will necessarily reduce the beneficiary's share of the fund. If the volunteer makes further deposits of his own money, that money should not be impressed with a trust, lien or charge in favour of the beneficiary unless the volunteer appropriates the deposits in that manner.

If withdrawals exceed the volunteer's proportional share of the fund, then notwithstanding the reduction of the beneficiary's proprietary interest, the beneficiary should be entitled to a personal remedy against the volunteer. The volunteer should be obliged to account for any benefit received in excess of his interest in the fund. The volunteer should be able to raise the defence of change of position, whether the beneficiary's claim
is for a personal or a proprietary remedy. If withdrawals from the fund are traceable, it should follow that the beneficiary's lien or charge should persist against that traceable product. Provided there is no deficit

to account for, the equities of the beneficiary and the volunteer are equal. But if the volunteer has had the use of the beneficiary's money, the equities are no longer equal. In neither case should the rule in *Clayton's Case* apply.

Lord Greene, M.R., however, concluded that *Clayton's Case* was applicable with reference to several of the claims against volunteers:

> The above result would only follow if *Clayton's Case* applies. It might be suggested that the corollary of treating two claimants on a mixed fund as interested rateably should be that withdrawals out of the fund ought to be attributed rateably to the interests of both claimants. But in the case of an active banking account this would lead to the greatest difficulty and complication in practice and might in many cases raise questions incapable of solution. What then is to be done? In our opinion, the same rule as that applied in *Clayton's Case* should be applied. This is really a rule of convenience based upon socalled presumed intention. It has been applied in the case of two beneficiaries whose trust money has been paid into a mixed banking account from which drawings were subsequently made, and, so far as we know, its application has not been adversely criticized (see per Fry J. in *Hallett's* case and per North J. in *In re Stenning*.) In such a case both claimants are innocent, neither is in a fiduciary relation to the other, and if the mixed fund had not been drawn upon they would be entitled to rateable charges upon it. Exactly the same occurs where the claimants are not two beneficiaries but one beneficiary and one volunteer, and we think, accordingly, that the same principle should be adopted.

By applying the rule, with respect to the payments made to one charity the claimants were entitled to a charge on a funding loan, which was the traceable product of the mixed fund. The *Clayton's Case* rule dictated that the claimants' funds went into that funding loan. The claimants' interests were therefore not prejudiced by the rule in these circumstances.

With respect to another charity, the monies went into the purchase of stock, which was mixed with other like stock, some of which was later sold. The claimants argued that *Clayton's Case* should apply, the result of which would have been that

(i) the stock sold would be credited to the charity; and
(ii) the claimant's money would be represented by retained stock.

The court rejected this argument. It felt that *Clayton's Case* should be confined to the case of a bank account
alone:

> We do not accept the view that the case ought to be treated as though it were subject to the rule in *Clayton's Case*. We see no justification for extending that rule beyond the case of a banking account. Here, before the sales took place, the mass of stock, if the question had then been raised, would have been regarded in equity as belonging rateably to the charity and to the Diplock estate. The only equitable way of treating the situation appears to us to be to regard each sum of stock withdrawn from the mass as having been made up in the same proportions. In so far as, upon this principle, withdrawals represented in part Diplock money and the sums received on the sale of the stock withdrawn were expended on general purposes and cannot now be traced into any existing asset, that amount of Diplock money must be regarded as having disappeared. But in respect of so much of the Diplock interest as is not thus accounted for, we are of opinion that the claim to a rateable proportion of the stock still held is established.

In the result, therefore, the claimants and the volunteers each bore their proportional share of the shortfall. No account was taken, however, of the benefit received by the volunteers from the use of the mixture which caused the shortfall.

E. Change of Position

The defence of change of position applies where, on the strength of receiving a benefit to which he bona fide believed himself to be entitled, the recipient uses it in such a way that it would be inequitable to compel him to repay it. If a volunteer receives a gift, which he uses for something he would otherwise not have done, he may raise the defence of change of position to resist repaying the benefit. We discussed

this defence in some detail in our *Report on Benefits Conferred Under a Mistake of Law* (LRC 51 1981) and the following is based upon that discussion.

At common law, the defence is fairly circumscribed. In England, no general defence of change of position is yet recognized although its essential elements are recognized in other contexts. It is, for example, said to be an element of an estoppel.

In Canada, a general restitutionary defence of change of position is recognized. In *Rural Municipality of Storthoaks* v. *Mobil Oil*, the respondent made payments required under a lease on the mistaken assumption that it was in effect. In fact, the lease had been surrendered. On discovering the error, the respondent successfully brought an action to recover the payments as money paid under a mistake of fact. On appeal to the Supreme Court of Canada, the municipality argued that it had changed its position in reliance upon the money paid to them. While the court expressed the view that the defence was a proper one, on the facts of the
case, it could not be applied. The Supreme Court of Canada held that the defence of change of position requires both reliance on the receipt of money and detriment to the receiving party.

The issue of what constitutes detriment to the recipient is not yet certain. In recent cases the courts have held that repayment would be "inequitable" because it would cause hardship. The payment of any large amount would in most cases cause "hardship," but it is difficult to see why recovery would be inequitable for that reason alone.

An early and limited application of the defence of change of position, in the context of proprietary remedies, is to be found in the court's treatment of volunteers in *Re Diplock*. The usual rule is that trust property remains subject to the trust in anyone's hands except those of a bona fide purchaser for value who obtains legal title without notice. A volunteer is subject to any burden or equity imposed upon property. It was held in *Re Diplock*, however, that the interest of an innocent volunteer in a mixed fund, to the extent his property was concerned, was equal to the claimant's interest, on the basis that the equities of the parties were equal. If an innocent volunteer uses the mixed fund to make improvements or alterations to his land, then, it was said, a claimant has no remedy for three reasons: the value of the premises may not increase; the remedy would include powers of sale so that an unfair burden would be placed on a volunteer who had no equivalent remedy against the claimant; and if a claimant were entitled to a charge, it would be impossible to determine what that charge should attach to. The basis of these reasons is the principle that a claimant may not trace if the innocent volunteer cannot be restored to his original position, or if depriving an innocent volunteer of the benefit he has received will leave him worse off than before it was received.

It is, however, a question of fact whether the volunteer's use of the money has reduced the benefit he received. It must be observed that in *Re Diplock*, the issues were examined from the viewpoint of equity rather than that of restitution. Restitution has not been generally accepted in England.

The defence of change of position is essentially restitutionary in nature. Unlike most remedies at law or in equity, which aim at compensating the plaintiff, compensation is not a paramount consideration in restitution. Restitution aims at the removal and the return of a benefit which the defendant in good faith and conscience cannot retain. It follows that if the defendant either has not been benefited, or has changed his position so that repayment of the benefit would be onerous, there should be no restitutionary remedy.

The defence, if the American pattern is followed,

142. Change of Circumstances

(1) The right of a person to restitution from another because of a benefit received is terminated or diminished if, after the receipt of the benefit, circumstances have so changed that it would be inequitable to require the other to make full restitution.

(2) Change of circumstances may be a defense or a partial defense if the conduct of the recipient was not tortious and he was no more at fault for his receipt, retention or dealing with the subject matter than was the claimant.

(3) Change of circumstances is not a defense if

(a) the conduct of the recipient in obtaining, retaining or dealing with the subject matter was tortious, or

(b) the change occurred after the recipient had knowledge of the facts entitling the other to restitution and had an opportunity to make restitution. should lie when the defendant acts in good faith without notice and his actions reduce the benefit he has received. And the defence should apply only where the equities involved are equal or the defendant has a greater equity. If the defendant would normally have made the expenditure or could well have afforded to make it, then the defence should not lie; but where the benefit has induced the defendant to live or invest beyond his means, regardless that the traceable portion of the monies went into an investment he could otherwise afford, he should be entitled to the defence. So too should the defence be available if the benefit is lost or stolen, regardless of the defendant's care or negligence:

> The basis of the liability of an innocent defendant is the benefit he retains at the plaintiff's expense, and not the lack of care with which he treats property he believes to be his own.

Canadian courts have affirmed that expenditure alone will not establish the defence. The question posed in *Storthoaks* is whether there is something in addition to the mere liability to repay which makes it more appropriate that the plaintiff, rather than the defendant, bear the loss. It is submitted that liability to pay a large judgment alone is not inequitable, nor were the grounds asserted in *Re Diplock* for protecting the volunteers who received the estate assets. Canadian courts appear to have abandoned the relatively narrow confines of change of position for the open range of "natural justice and equity." It is not yet clear what limits will be placed on that inquiry in future cases.

In our *Report on Benefits Conferred Under a Mistake of Law*, we considered whether legislation with respect to change of position should be enacted. We concluded that it would be unwise at this time to enact such legislation for the principal reason that the defence is still in its formative stages. Crystallization in legislation may impair development of the defence in the law of restitution.

F. Separate Accounts

A question similar to those discussed above arises when a trustee holds several accounts, each consisting of mixed funds. If the trustee removes money from those accounts, but one account is exhausted while others still retain funds, should the beneficiaries of the trusts be treated as one class, and the accounts as one account?

Where the law defines separate classes, it makes no difference that they were treated as one class by their fiduciary. In *Ontario Securities Commission* v. *Xantrex Management Corporation*, the defendants set up various subsidiary companies to solicit funds from investors for speculation in bullion. There was some evidence of funds being transferred between the companies. Upon their liquidation, it was found that the company that dealt with the Ontario investors had sufficient funds to pay them in full. The British Columbia company did not possess sufficient funds to satisfy the outstanding claims of its investors. It was held that the Ontario investors could trace into funds of the Ontario company, and they were paid in full. The B.C. investors could trace into the assets of the B.C. company, only, and suffered a substantial shortfall. A more reasonable result, since there was evidence the two companies had been treated as one company and their assets jointly used, would have been to let all the investors participate *pari passu*.

In *Re WindingUp Act; Re Saskatchewan General Trusts Corp*., a trust company deposited all trust funds into a general trust account from which it frequently withdrew funds to pay current corporate expenses. The ultimate product of the funds was traceable, but the specific trusts contributing the funds to the account were not identifiable. It was held that the trust creditors could not be treated as one class even though the trust company had so regarded them. Because it was impossible to tell from which estates the money had been borrowed, the trust creditors could not be given priority. However, the trust creditors, rather than lose all priority, agreed among themselves to be treated as a class, and a lien was granted in their favour until all

the trust accounts were paid in full. It is surprising that the final resolution could be approved, but not ordered, by a court, given that the end result was just to all parties.

G. Rebutting the Presumption Raised by *Clayton's Case*

It is instructive to review some of the cases in which courts have refused to apply *Clayton's Case*, and the reasons for that refusal. Their reasons suggest that the Courts will sometimes go to great lengths to avoid applying the rule. In several cases the reason which prompted the courts was merely the desire to avoid unjust results.

The rule in *Clayton's Case* is a presumption, which may be rebutted by evidence raising another presumption, by trade practice, by an absence of evidence or by invoking a resulting trust.

1. Rebutted by Evidence Raising Another Presumption

We observed earlier that the rule in *Clayton's Case*, in its inception, was a presumption raised by the circumstances of the case before the court. Subsequent cases raised it to the status of a rule rebuttable only by express intention or agreement. Nevertheless, one need only look to *Re Hallett's Estate* for support for the proposition that the circumstances may dictate that a more appropriate presumption should apply:

> [*Clayton's Case* is] ... a very convenient rule, and I have nothing to say against it unless there is evidence either of an agreement to the contrary or circumstances from which a contrary intention must be presumed, and then of course that which is a mere presumption of law gives way to those other considerations.

2. Rebutted by Trade Practice

A series of cases brought about by the 1929 stock market crash and the depression, involved clients of insolvent stock brokers, who had pledged their client's shares to secure their indebtedness to the bank. A broker was authorized to pledge shares purchased on behalf of clients for which full payment had not been received, but not shares for which full payment had been received. Upon a broker's insolvency, the bank would sell the shares. The result was an inextricable mixture of securities or of money in a common fund, to which the owners of the pledged shares asserted proprietary rights.

A reasonable course, given the weight of authority in its favour, was to apply the rule in *Clayton's Case* to withdrawals made from the common fund of money. However, the courts, following American law, treated remaining securities and the fund of money as a common asset in which the owners of pledged securities shared *pro rata*. This was called "sharing the burden of the loan." The single exception to this principle arose when an owner of pledged securities could identify his actual shares, or the proceeds from their sale, if they had not been inextricably mixed with other securities, or with other monies.

3. Rebutted by an Absence of Evidence

If the order in which deposits are made is not known, the rule in *Clayton's Case* cannot be applied. In *Re Cohen* a solicitor used trust monies drawn from his general trust account to pay off a mortgage. No evidence was led to indicate in what order trust monies were deposited in that account. Whether there actually was no evidence, or counsel neglected to lead it, is not indicated in the case. The mortgage was never discharged. Beneficiaries of the trust account argued they were entitled to trace into the mortgage security. It was held that the beneficiaries of the solicitor's trust funds ranked equally as beneficiaries of a trust of the
mortgage:

The doctrine in *Clayton's Case* ... which attributes the first drawings out to the first payments in, cannot be applied in the absence of evidence on that point.

4. Rebutted by Finding a Resulting Trust

In *Re British Red Cross Balkan Fund; British Red Cross Society* v. *Johnson*, a fund was raised by subscription for the assistance of the sick and wounded in the Balkan War. After the purpose of this trust was completed, a question arose respecting disposition of the unexpended balance of the fund. If the rule in *Clayton's Case* applied, then those subscribers who contributed after November 8, 1912 would be paid in full. If the rule were not applied, all subscribers would share pro rata in the remainder of the fund.

It was held that the rule in *Clayton's Case* did not apply, and a resulting trust arose in favour of all subscribers rateably in proportion to their subscriptions, irrespective of when the subscription was made. This case has been criticized on the ground that merely invoking a resulting trust would not rebut the rule in *Clayton's Case*. A resulting trust would arise only in favour of those who retained property in the fund. That question, according to substantial precedent, is resolved by the rule in *Clayton's Case*.

Another reading of the case is possible. The court merely held that the rule in *Clayton's Case* was not supported by the circumstances of the case, an approach, we have argued, which is open to a court. It was said:

> It is a mere rule of evidence and not an invariable rule of law, and the circumstances of any particular case may or may not afford ground for inferring that the transactions of the parties were not intended to come under the general rule.
>
> In the present case the rule is obviously inapplicable.

The court did not provide reasons why the rule was inapplicable, and in that respect the decision is not wholly satisfactory. Nevertheless, it is difficult to provide reasons why the rule is inapplicable in the circumstances when the only argument in favour of the rule is equally weak. How does one argue against the assumption that "there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place ...," the reason given in favour of *Clayton's Case*? That argument is axiomatic. It cannot be proved. Neither can it be disproved.

CHAPTER V REFORM

A. Generally

From our earlier discussion the following facts have emerged. The rule in *Clayton's Case* was derived from the law respecting the appropriation of payments made where a debtor owed his creditor two or more separate debts. No presumption arose in that context, although in some circumstances the courts might infer
an intention to apply a payment to one debt over another. The rule in *Clayton's Case* was designed to apply to dealings between a banker and depositor with respect to a single bank account. In that context it appears to operate fairly well. It has subsequently been applied in a number of other contexts where it is neither needed nor appropriate for the functions it has been made to perform.

Its first expanded use appears to have been with respect to several separate debts owed by a debtor to a creditor. Prior to *Clayton's Case* the law functioned well without the rule. One can only assume that the law was prepared to apply the rule, and tolerate the often unjust results obtained by it, in the interests of certainty. Nineteenth century courts were dedicated to achieving certainty, and consequently developed a vast array of arbitrary presumptions for that purpose. A 20th century trend has been to do away with those presumptions. Usually, repealing an arbitrary presumption does not sacrifice certainty.

Later the rule was applied to determine interests between parties whose money had been mixed by the depositor with monies in his own bank account. An arbitrary rule, developed to describe banking practice and dealings between debtors and creditors, had no place in determining priorities between one whose money had been wrongfully taken by another and mixed with other money. Rather than attempt to define what principle of law should apply, the law developed other fictions to deal with the problem, such as, a trustee is presumed to withdraw his own money first, or a trustee is presumed to act honestly. These fictions generated more general fictions, such as, a trustee may not invoke his own wrong as a defence, or all presumptions are against the trustee. These fictions operated well only in particular fact patterns. There was still a need to define the principles of law involved. Nineteenth century law, however, was fond of fictions. A 20th century trend has been to do away with fictions.

A principle defect with the rule in *Clayton's Case* is that the fiction it prescribes rests upon another unstated fiction. Of these fictions, one is false and the other, in the context of determining priorities to mixed funds, is unnecessary. The fiction upon which *Clayton's Case* rests is that money is actually deposited in an account. Money is not deposited in an account. When money is deposited with a bank, debt is purchased. Debt can be envisioned in several ways. It can be regarded as consisting of many separate debts. Or, like money, it can be viewed as a consistent body of indistinguishable parts. Whichever model is used is unimportant.

The rule in *Clayton's Case* describes in what order money deposited in a bank account is withdrawn. Order of withdrawal is an unnecessary fiction. Except as between banker and depositor, that information is immaterial. The law's treatment of other funds of inextricably mixed goods is more sensible. Upon mixture, the mass of goods belongs to the owners of goods contributed, in the proportion of their contribution. The only real question to be determined is whether any of a claimant's property remains in a fund. That is a question which can be answered in every case without reference to a fiction.

Professor McConville has drawn the following conclusions respecting the rule in *Clayton's Case*:

> A bank account is not a debt owed by the banker, in these cases, but an asset in the hands of the trustee, like a box or repository, in which there is a confusion of notes and coins, some of which belong to the trust fund, but which particular ones it is impossible to distinguish from the rest. The rules indicate where and how much trust money might have either remained in the account or found its way out of the account and into another form, as the result of subsequent transactions. Having identified the asset, whether the account or some other form, the equitable remedy comes into operation, by virtue of which the asset is charged to the amount of the trust fund, either in full or in part, as indicated by the rules, and, in appropriate cases, by the beneficiary's election. Equity will never attempt to unravel an account or to determine which particular notes and coins belong to the trust fund. Since the rule in *Clayton's Case* relates merely to the mode of accounting adopted between the trustee and his banker, it is immaterial to the question who is entitled or has the better right to the asset, that the bank account is in the hands of the trustee.
>
> The real problem in all these cases is one of confusion of identical property, which is resolved by applying the device of a charge. In this way the beneficiary recovers the trust property in priority to the trustee recovering what is his own. To be able to claim such a remedy, one must be asserting a proprietary right, hence the claim must be based on some form of equitable title. A claimant will have an equitable title if he can show that in respect of the original money or property a fiduciary duty was owed to him. This is the real significance of the fiduciary relationship and why it is so essential to the granting of this mode of equitable relief.
>
> In conclusion, it is submitted the rule in *Clayton's Case* does not apply to any tracing situation and that it should be confined to its proper sphere in the law of debtor and creditor. The dual nature of a bank account should be recognised and the fiction of "presumed intention" discarded. Tracing depends on strictly proprietary principles deducible from *Re Oatway and Roscoe* v. *Winder*, which mark the proper limits of the action.
>
> Some of these conclusions may appear to militate against accepted principles of equity, particularly in respect of *Clayton's Case*, but it is submitted the introduction of this case into the law of tracing arose from a confusion of two unconnected branches of law, deceptively similar in that they both relate to bank accounts. In view of the fact that the underlying principles have only once been examined and the authorities are conflicting, it is hoped a modern court might feel at liberty to remodel the law of tracing on more rational lines in this respect by holding *Clayton's Case* to be irrelevant.

We agree with Professor McConville. Nevertheless, given the preponderance of case authority in favour of the rule in *Clayton's Case*, we doubt whether courts will depart from it. There is a need for legislative action.

B. The Position in the United States

In some states the courts continue to apply the rule in *Clayton's Case* in circumstances other than disputes between debtors and creditors. In most states, however, the rule is not applied. Professor Scott has made the following observations:

> As between the depositor and the bankers this rule is fair enough ... In cases of a wrongful mingling of deposits by the depositor, however, the reasons underlying the rule are wholly inapplicable in determining the relation between the wrongdoer and the claimant. By depositing the whole in one account, the wrongdoer has confused his money with that of the claimant, as inextricably as though he had physically mingled the money. He has, by the use of the two funds, acquired a single chose in action. That whole chose in action therefore is subject to an equitable lien of the claimant, or beneficially belongs in part to him. The wrongdoer, whatever his intent, cannot shake off the interest of the claimant in the chose in action. To make the rights of the claimant depend upon the purely accidental circumstances of the order of deposits is arbitrary and unfair. Although *Pennell* v. *Deffell* was followed in *Brown* v. *Adams*, decided in 1869, it was expressly overruled in *In re Hallett's Estate* decided in 1880. In the United States the courts have not followed *Pennell* v. *Deffell*, but have frequently cited In *Re Hallett's Estate* with approval.

In 1936 the American Law Institute prepared the Restatement of the Law of Restitution. That work purports to state the law of restitution in the form of a code. Provisions of the Restatement respecting tracing and the rule in *Clayton's Case* are contained in an appendix to this Report.

Briefly, the Restatement provides that a person who has legal or equitable title to property may follow or trace that property. There is no need for a fiduciary relationship in order to pursue proprietary remedies originally formulated in equity. If the property followed is money, the claimant is entitled to an equitable lien if it has been mixed with other money, or to a constructive trust if it is the sole consideration used to purchase
another asset. If a volunteer receives the money, the claimant is entitled to a lien on the fund or its traceable product unless the volunteer elects to repay the benefit. The rule in *Clayton's Case* is specifically excluded when determining a claimant's entitlement.

We agree with this approach. We are reluctant, however, to propose the enactment of legislation based upon the Restatement. In our opinion, the real need in British Columbia is to remove anomalies in the law that result from concepts of legal and equitable title, although our aim is not to achieve a true fusion of law and equity. If *Clayton's Case* is to be inapplicable, we think enactment of fundamental principles or rules with respect to available remedies is essential to guide the courts in the absence of the rule. To some extent such legislation will restate the current law. Although some restatement is inevitable, care should be taken to keep it to a minimum. The Restatement goes too far in that it attempts to codify all of the law with respect to tracing. As we observed earlier, only in the past 30 years, with the acceptance in Canadian law of the principles of restitution, have the analytical tools necessary for understanding and refining the law of tracing been available. Codification of the law of tracing can only result in stultifying the development of the law.
Moreover, many portions of the Restatement regarding tracing pertain to the use of the remedial constructive trust. A remedial constructive trust has only been accepted in Canadian law since 1977. It is too soon to define legislatively what principles should govern this new development in Canadian law.

C. Exceptions in Canada

We have already noted some exceptions to the rule in *Clayton's Case* in Canadian law.

1. Stock Brokerage

(a) The Current Law

In Canada, the rule in *Clayton's Case* is not applied between clients of an insolvent stock broker, who, with or without authority, pledges shares to secure his personal indebtedness. Whether shares are mixed, or sold and the proceeds mixed, the rule does not apply. Deficiencies are shared pari passu. This is known as the doctrine of sharing the burden of the loan. That doctrine was borrowed from American law. In England *Clayton's Case* would be applied if proceeds from the sale of pledged stocks were mixed and withdrawals made from that mixture.

(b) The Bankruptcy and Insolvency Bill

During the last decade bankruptcy reform has occupied the federal government. One aspect of bankruptcy not dealt with by the current Act is priorities between customers and creditors of insolvent securities firms. The current law in this area, we have observed, modifies common law and equitable principles of tracing. As well as abandoning the rule in *Clayton's Case* with respect to mixed trust funds held by or on behalf of stock brokers, the law provides that those assets which represent customer's securities constitute one fund in which all customers share pari passu. An exception to this principle is made if property belonging to particular customers remains identifiable.

A number of options for resolving priorities among claimants of insolvent securities houses have been explored by policy analysts and draftsmen responsible for settling a new *Bankruptcy and Insolvency Bill* for Canada. The most radical option was to regard all unsecured assets of a securities house as one fund in which customers and trade creditors share rateably. That option has been universally rejected because in many respects it would be grossly unfair to customers of the securities firm. It is difficult to escape the fundamental principle upon which tracing at law or in equity rests. A claimant should be entitled to his identifiable property. That property should not be used, even in part, to satisfy the claims of general creditors.

A compromise between this option and the common law, adopted in Bill C60, was to divide those assets representing property of customers from other unsecured assets. Customers would share rateably in the asset base representing their property, and general creditors together with customers whose claims were not
satisfied would share rateably in the remaining assets. This option generally preserved common law concepts of identifiability or tracing, but removed the need to actually identify specific property. It differed from the common law in that it prevented a customer from claiming his actual property even when it was identifiable. In many respects this option would operate fairly in circumstances of insolvency. Nevertheless it received severe criticism. It was generally felt that a customer should be entitled to his money or securities which remained identifiable. Moreover, this option did not take into account the fact that the securities industry maintained a contingency fund or insurance scheme to protect customers whose property deposited with a securities firm was no longer identifiable.

In subsequent drafts of new bankruptcy legislation, another option has been favoured. That option focuses upon whether customer's claims are insured. If there is insurance, the model followed in Bill C60 applies. Separate pools of customer assets and creditor assets are identified and customers and creditors share pari passu in their separate funds. If insurance is not available, customers may trace their specific property, and the remaining property is again divided into separate pools of customer assets and creditor assets.

The significance of these approaches is twofold:

(i) they evidence a legislative modification of the common law requirement that property must be identifiable before a proprietary remedy is available; and

(ii) none of them depends upon the rule in *Clayton's Case*.

The concept of identifiability relates only to locating the asset pool or base in which a customer's property has been mixed. After that, fairness demands that customers share that fund *pari passu*. The exception made for actually identifiable property when insurance is unavailable does not contradict these principles. Tracing at law or in equity is unobjectionable when all that is sought is the return of the claimant's actual property. It is
objectionable when it determines priorities between claimants based upon fictions or presumptions aimed at notionally identifying property which no longer remains identifiable.

2. Mixture of Goods

At law, if goods are wrongfully or innocently mixed, the owners of the goods are regarded as owning the mass as tenants in common. Shortfalls are borne equally if the mixture is innocent. Shortfalls are borne by the wrongdoer if the mixture is wrongful. In *Re Diplock*, for example, it was expressly held that the rule in *Clayton's Case* should not apply other than to an active bank account. In that case it was held that the rule did not apply when shares were mixed and some were withdrawn.

D. Reform

The subject of this Report is complex, and recommendations for reform will tend to be similarly complex. In order to combine statements of clearly understandable principle with a rigorous and precise definition of necessary reform, we will discuss possible legislative approaches for reform. Our recommendations will be in the form of the general principles we think should be modified. These recommendations will be followed by draft legislation which addresses those particular aspects of the law which, we have concluded, should be revised. Although we feel this approach is the best means of clearly stating our conclusions, the complexity of this area of the law does not lend itself to simple propositions for reform. Our recommendations, in the pursuit of comprehensibility, may lack some precision. That lack of precision, it is our hope, is compensated by the more rigorous statements contained in the draft legislation.

1. Application of the Rule Between Depositor and Bank

We observed earlier that with respect to a depositor and his bank, the rule probably functions adequately. In the simple case of determining the appropriation of debt and credit transactions within a single bank account, no problems appear to arise from viewing withdrawals as occurring in the same order as deposits were made.

Although the rule has been applied to allocate credit against separate debts, that does not appear to be the current practice. There is, however, a fine line between separate debts, and a single debt of which part is secured and part is not. Probably the rule should not apply in that context, although the Cases demonstrate that it has been. Nevertheless, we make no recommendation to alter the operation of the rule between a debtor
and creditor, for example, a depositor and bank. No recent Cases disclose that problems arise from the rule in *Clayton's Case* in this context. There is no call for reform.All moneys collected or received by the Bank in respect of the assigned premises (whether by virtue of paragraph 5 hereof or otherwise howsoever) may be applied on account of such parts of the indebtedness and liability of the undersigned as to the Bank seems best or in the discretion of the Bank may be released to the undersigned, all without prejudice to the Bank's claims upon the undersigned.

In a Bill of Sale by Way of Mortgage, in addition to a provision similar to the above, clauses will ensure the security will continue, notwithstanding changes in partnership, or the form in which the accounts are kept. The following provisions are typical:

THAT this mortgage shall stand as a continuing security for the payment of all such indebtedness and of all interest and other moneys secured or intended to be secured hereby and for the due and proper payment thereof and of every part thereof as and when the same shall become payable to the Mortgagee notwithstanding any change in the nature or form of such indebtedness or in the accounts or in the bills of exchange, promissory notes and/or other obligations now or from time to time hereafter held by the Mortgagee representing the same or any part thereof or in the names of the parties to such bills, notes and/or other obligations or any change or changes in the name of the Mortgagor or (in the event that the Mortgagor be a partnership) any change or changes in the member-

> ship of the Mortgagor's firm by the death or by the retirement of one or more of the partners or by the introduction of one or more other partners;
>
> THAT the amount of the Mortgagor's indebtedness to the Mortgagee existing at the date of this mortgage shall be secured hereby notwithstanding the form in which the accounts with the Mortgagor may be kept, or any new transactions with the Mortgagor by way of further loans, discounts or advances, or the deposit or withdrawal of moneys by the Mortgagor, or the crediting or debiting of amounts in the said accounts;

A guarantee is often made in the form of a continuing guarantee securing the "ultimate balance due." A clause like the following effectively avoids the rule in *Clayton's Case*:

> That this shall be a continuing guarantee and shall cover present liabilities (if any) of the customer to the Bank and all liabilities incurred after the date hereof and shall apply to and secure any ultimate balance due or remaining due to the Bank and shall be binding as a continuing security on the Guarantor, provided that the Guarantor or the executors or administrators of the Guarantor may determine his or their further liability under this guarantee by thirty days' written notice given to the branch of the Bank at which this guarantee is held and this guarantee shall not apply to any liabilities of the customer to the Bank incurred after the expiration of thirty days from the receipt of such notice by the said branch.

In Falconbridge, *Banking and Bills of Exchange*, (7th ed., 1969), it is said (at 2812):

> On the death of a surety for a current account, it is common practice for the bank to close the account and open a fresh one with a customer, in order to protect the surety's estate from getting the benefit of subsequent payments made to current account by the customer. [The following cases are cited: *Re Sherry*, (1884) 25 Ch. D. 692; *Deeley* v. *Lloyds Bank Ltd*., [1912] A.C. 756].

By these means, potential problems arising from the rule in *Clayton's Case* are avoided. Our principal concern, in any event, is not with the rule's application between creditor and debtor, but with the application of the rule when other interests are involved.

2. The Need for the Rule in Clayton's Case

A claimant whose claim is based upon an equitable interest alone, in addition to personal remedies available in equity, is entitled to an equitable lien or charge on the fund or its traceable product. Those remedies do not depend upon ascertaining the order in which withdrawals are allocated against deposits. The only questions which must be answered are:

(i) Was the claimant's money deposited in that fund? and
(ii) After deposit, and before the mixture of other monies (other than the depositor's), what was the minimum balance of the account?

In the Working Paper, we tentatively concluded that the rule in *Clayton's Case* was unnecessary to determine either of these questions, and should be abolished. Our correspondents agreed. We see no reason to depart from that conclusion.

The Commission recommends that:

1. The presumption in Clayton's Case *should not apply to ascertain the order in which monies are drawn from an account for the purposes of the equitable doctrine of tracing.*

Legislation pursuant to this recommendation might take the following form:

Except to determine rights between a debtor and his creditor, there is no rule or presumption that withdrawals from a fund are appropriated against deposits in the order in which they occur.

3. Tracing and Following

The result of abolishing the rule in *Clayton's Case* is that claimants will share rateably in a mixed fund. In the Working Paper, we tentatively concluded that, while that approach was adequate, it was desirable to clarify aspects of the equitable rules governing tracing. We made proposals designed to rationalize those principles.

While most of the comment on that portion of the Working Paper was favourable, one correspondent questioned several assumptions fundamental to tracing. It was suggested that consideration should be given to whether the concept of tracing ought to be retained at all.

To trace, it is necessary for the claimant to be able to identify his property or its substitute. When property is transformed into some other kind of property, there is a certain artificiality in recognizing

property rights in the new property. This is most clear when one considers the problems posed by identifying money in a bank account.

Our correspondent suggested that the status of a claimant, determined by his relationship with the person who deprived him of his property, together with the claimant's course of conduct, should determine his rights. For example, all people in a similar relationship with the wrongdoer, who are similarly prejudiced by the wrongdoer's acts, should share equally in remaining property. Tracing might operate to indicate what assets
the various claimants' property went into, but all of these assets should be considered as a common fund in which the claimants would share.

Determining the claimant's status, priorities or rights by this approach, is significantly limited by the qualification represented by course of conduct. Our correspondent writes:

> I see the essential concern, in determining the relative equities of the claimants, as their individual courses of conduct. To my mind the extent to which the claimant acted or might have acted to protect himself, and the cost and availability of insurance to each claimant, are typical vital considerations, to which I would merely add a broadly applied 'change of position' defence.

Whether this approach simplifies tracing or virtually abolishes it is difficult to say. A principal, seeking to trace the substitute for property misappropriated by his agent, may be met with the argument that the agent should have been bonded. A claimant trying to recover the substitute for property stolen from him, perhaps should have insured against theft. Perhaps insurance in these Cases is so common that tracing is really irrelevant, except from the viewpoint of the insurer who is subrogated to the claim of his insured.

While this approach is intriguing, we find it difficult to escape the fundamental principle upon which tracing rests. It makes no difference in reason or law how property is transformed. The substitute represents the original property, unless it can no longer be identified. The claimant is entitled to the return of his property. If his property is exchanged for other property, in most Cases the needs of commerce prevent him from recovering the original property. No one, however, has a better right to the property for which it was exchanged.

Identifying property of several people certainly poses problems, but that is not reason enough to foreclose their rights to their property. We have concluded, therefore, that it is undesirable to abandon tracing's foundation of property rights. Our recommendations are aimed at restoring to the equitable principles governing tracing that foundation. Our recommendation to abolish *Clayton's Case* is the first and most important step toward accomplishing that goal.

4. Application of the Rule when Interests Other than Those of the Depositor and his Bank are Involved

(a) Need for a Fiduciary Relationship

The rule in *Clayton's Case* tended to operate unfairly when money belonging at law or in equity to another was mixed in an active bank account. By applying the rule, often one beneficiary of the fund was required to bear the entire shortfall, while the claims of other beneficiaries were satisfied in full.

Quite apart from application of the rule, the position of a claimant who possesses both legal and equitable title to money in a fund, or who has been wrongfully deprived of his title by another, is unclear. Equitable remedies are not available to him, and remedies at law are often unsatisfactory.

In the Working Paper, we concluded that it should make no difference whether a person's claim is based upon a legal interest, a legal and an equitable interest, or upon an equitable interest alone. A fiduci-

ary relationship should not be necessary to trace in equity. A person who has only legal title to property or legal
title to property combined with its beneficial interest should be entitled to trace in equity, just as a person who is owed fiduciary duties may trace.

Comment we received supported this conclusion. Indeed, it was observed that recent developments in the law, particularly with respect to the remedial constructive trust, may already have removed the need for a fiduciary relationship to trace, or made that requirement irrelevant.

As we observed earlier, the courts have adopted various means of avoiding the requirement for a fiduciary relationship. Whether recent Cases have successfully removed that requirement is uncertain. We have concluded that it is desirable to confirm this aspect of the law through legislation.

Concern was expressed that, while awkward, the need for a fiduciary relationship prevented equitable tracing principles from slipping into the marketplace. Certainty of title, essential to commerce, is jeopardized if the interests acquired by *bona fide* purchasers for value and by secured creditors can be challenged by a person asserting an equitable interest. Several recent English cases have involved trade creditors who attempted to secure their positions through the retention of unregistrable equitable interests in goods supplied to manufacturers. How far that approach is effective is uncertain.

Removing the need for a fiduciary relationship will not, however, suddenly permit general creditors to trace and assert priority over secured creditors or other general creditors. The key to tracing is that the claimant follows his property. The threshold requirement is that the claimant has an interest in property. A person who loans another money, or supplies goods or services on credit, does not retain an interest in property. The retention of title approach that is being tested in England and Europe is unlikely to be effective in British Columbia, where legislation governing interests in property requires their registration to be effective against third parties.

Professor Fridman observes:

> The Commission's first and fundamental proposal is that, to found an equitable tracing remedy, there need be no fiduciary relationship between the claimant and the one from whom a remedy is being sought. Much ink has been spilled over the question whether the law now makes such a relationship mandatory. Goff & Jones argues that the *ratio decidendi of Sinclair* v. *Brougham* did not involve any such decision, although *Re Diplock* gave credence to the alternative view. These authors are of the opinion that probably the need for a fiduciary relationship was overemphasized but that in any event the broad way in which courts have interpreted the expression "fiduciary" may have rendered the argument otiose. It is doubtful whether anyone will regret the elimination of this ingredient of a valid equitable tracing claim. Equity has come a long way since the invention of the trust and the foundation of equitable intervention on the existence of a trust relationship or its equivalent or analogue. Where resitutionary remedies are involved, as in the situations to which *Clayton's Case* and rules of tracing apply, all that should be necessary for the claimant to establish is that the property claimed, whether money or anything else, was owned by the claimant as legal or equitable owner. Only if that title has been extinguished as a result of the application of some rule of law or equity should the claim be denied. What the Commission proposes is that the claimant be given an equitable lien to the proceeds of his money or on a fund in which his money (or the proceeds of his property) have been confused. This would entitle such claimant to obtain the assistance of the court in the enforcement of his rights of ownership.

The Commission recommends:

2. (a) A fiduciary relationship should not be necessary to found an equitable tracing remedy.

(b) A person who, whether owed fiduciary duties or not, has been wrongfully deprived of property, in tracing into a mixed fund is entitled to an equitable lien against the proceeds of that property, notwithstanding that it has been mixed with other property.

In order to abolish the need for a fiduciary relationship to trace in equity, legislation comparable to the following might be enacted:

A person deprived of property in which he has an interest is entitled, to the extent of that interest, to

(i) an equitable lien on the proceeds of that property, or
(ii) an equitable lien on a fund in which his property or its proceeds have been commingled.

The term "proceeds" is used to denote identifiable property in any form derived directly or indirectly from dealing with the person's original property. Other terms, such as the property's "substitute" or its "exchange product" have been used in this context in reported cases and academic literature. The term "proceeds," however, has been used in other legislation to denote that concept. For example, in the *Model Uniform Personal Property Security Act* (MUPPSA), "proceeds" is used to mean "identifiable or traceable property in any form or fixtures derived directly or indirectly from any dealing with the collateral or proceeds therefrom ...". This follows, in part, the definition adopted in Article 9 of the American *Uniform Commercial Code*, which provides that proceeds "includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." Legislation enacting these proposals should define "proceeds" and the definition provided in the MUPPSA draft is a useful model.

We have used the general term, "interest," instead of a more precise formulation, such as "legal, beneficial or possessory right, or any combination of those rights, in or to property." If legislation is enacted along these lines, the meaning of "interest" can be clearly set out in a definition section to that legislation.

It should be observed that in the example given of possible legislation, no provision is made respecting property which has not been exchanged for some other kind of property, or mixed with other property. The draft gives a person a lien against "proceeds" (the exchange product of, or substitute for, property or a fund) or against a "fund" (a mixture of property or proceeds). If a person's property is not exchanged for other property, nor mixed with other property, nor otherwise transformed, he is entitled to its return. There is no need for an equitable lien.

It should also be observed that the draft does not refer to an equitable charge. In equity, a lien arises from the relationship of the parties (for example, a lien might arise from a solicitor/client relationship). A charge arises from their conduct. There is no distinction, other than how they arise, between these two remedies. For the purposes of legislation, only one need be provided. Neither an equitable lien nor an equitable charge persist against property which has been acquired by a bona fide purchaser for value without notice.

5. Effect of Transactions on a Mixed Fund

(a) Minimum Balance

The effect of an equitable lien or charge is that the claimant is entitled to repayment from a fund, against which the lien or charge lies, to the extent of that lien or charge. If the balance falls below the sum necessary to repay the claimant in full, his interest in, and consequently his lien against, that fund is reduced by the shortfall. An exception to this principle arises if money withdrawn from the fund can be traced. If withdrawals can be traced, the claimant's lien or charge lies against that money or its substitute, to the amount withdrawn from the fund. That principle, for clarity, could usefully be restated in legislation enacting recommendations 1 and 2.

(b) Unappropriated Deposits

Under the current law, if a trustee or fiduciary makes subsequent deposits, those deposits do not affect a person's interest in the fund, unless they are expressly appropriated to that person's interest by the

depositor. In our opinion that rule should be reversed. In the absence of express appropriation, it is not possible to determine whether a trustee who wrongfully removes trust funds, and then makes further deposits of his own money, intends to restore the trust. That question must be resolved by presumption. There is no reason why that presumption should prejudice persons with interests in the fund. Deposits, not expressly appropriated to an interest, should be deemed to restore the interest of a person in a fund that has been diminished by the wrongdoer's withdrawals. It is important to note, however, that a deposit of money, belonging legally or beneficially to someone other than the depositor, would not be unappropriated or subject to appropriation. Such a deposit could not be used to restore a depleted interest.

The Commission recommends that:

3. *A person with an interest in a fund should only be entitled to the lesser of the value of his interest and the minimum balance of that fund.*

4. *Unappropriated deposits of the wrongdoer's own money should restore a person's interest in a fund that has been diminished by the wrongdoer.*

Legislation enacting these recommendations might take the following form:

A person's interest in a fund is determined by the value of his interest in that property or in its proceeds mixed in that fund, except that

(i) if the balance of the fund falls below the person's interest, his interest is diminished by the shortfall;
(ii) additions to the fund by the wrongdoer, not attributable or expressly appropriated to another interest, are deemed to restore the person's interest.

It should be observed that this approach applies only when there is one claimant to the fund. If there is more than one claimant, their interests should be affected rateably by changes to the fund.

(c) Profit

The fund may be used to earn money, by investment or otherwise. There is some doubt under the current law whether a person with an interest in that fund is entitled to a portion of that profit. We think that legislation should confirm that a person who has an interest in a fund is entitled to a portion of that profit. There are two ways to determine that portion. For example, profit could be divided among those persons whose property has been mixed, in the proportion of their interest to the sum of those interests, exclusive of the wrongdoer's interest in the fund. That approach would have the effect of dividing profit only among persons whose property has been wrongfully mixed, exclusive of the interests, if any, of the person responsible for that mixing. Alternatively, the wrongdoer could be entitled to share *pro rata* with claimants to the fund.

Under the current law, rules have been developed to deprive a wrongdoer of profit earned at another's expense. Those rules should continue to function. In our opinion, since profit added to a fund, when divided among persons with interests in that fund, will increase their interests, prima facie they should only be entitled to that portion of profit attributable to their interest in the fund. In the event that the wrongdoer, under the current law, should be deprived of that portion of profit attributable to his interest in a mixed fund, his share would be divided among other interests in the fund. One means of accomplishing that, available under the current law, is the constructive trust. Since the current law provides a means of depriving a wrongdoer of profit earned at another's expense, we have concluded that it is not necessary for remedial legislation to address that issue.

The Commission recommends that:

5. *Profit earned by and added to a fund should be appropriated to a person's interest in a fund in the proportion that that person's interest bears to the whole of the fund.*

Legislation enacting this proposal might take the following form:

Profits earned by, or by the use of, the fund or part of it, and added to the fund, increase the person's interest in the fund by the proportionate share of those profits his interest bore to the whole of the fund.

(d) Competing Interests in a Fund

The depositor may mix into the fund monies belonging to other people. Where there are several claimants, they should share in the fund *pari passu*. The rule in *Clayton's Case* should not apply. It should be remembered, however, that a claimant's interest which has been diminished by the depositor's withdrawals,
is not increased by the deposit of another claimant's money. Under Recommendation 4, diminished interests are restored only by deposits of money belonging to the depositor who has wrongfully mixed property belonging to others.

The Commission recommends that:

6. *If there is more than one claimant to the fund, they should share* pari passu *in the fund or in any traceable or identifiable proceeds of that fund. [The mechanics of* pari passu *sharing are set out below, and in section 5 of the collected draft legislation in Chapter VI.]*

Terms like "*pari passu*," "*pro rata*," "rateably," and "proportionately" are inherently ambiguous. Do they mean that shortfalls or accretions to a fund are shared in proportion to the original interests claimants to that fund possessed? Or do they mean that shortfalls or accretions to a fund are shared in proportion to those interests claimants to that fund possess after each transaction made with respect to that fund is taken into account? In the Working Paper we tentatively concluded that the latter meaning was fairest.

For example, A, a trustee, deposits $1,000 of B's money in his account, mixing it with $1,000 of his own money. A removes $1,500. A then deposits $1,000 of C's money. B and C should not share the fund of $1,500 equally, notwithstanding that B's original interest in the fund was $1,000 and that C's current interest is $1,000. B's interest in the fund has been reduced by $500. B's lien should be reduced from securing $1,000 to now securing $500, the minimum balance of the fund following the deposit of his money and preceding the deposit of C's money. C would be entitled to a lien of $1,000. No transactions have occurred yet to reduce his interest in the fund. To avoid confusion, legislation enacting these recommendations should define exactly how "*pari passu*" sharing takes place. One possible formulation is as follows:

If there are two or more persons with interests in a fund, the amount of any shortfall from or accretion to the fund which would have affected their respective interests, and which is not appropriated to a specific interest or interests, is divided and attributed to their respective interests in such proportion as their respective interests bore to the sum of those interests before the shortfall or accretion occurred.

Several further examples should demonstrate how this approach would function.

Example 1:

T, a trustee, deposits $1000 he holds in trust for A, into his own account. At that time his account has no money in it. T then deposits $500 of his own money. T withdraws $500. *Clayton's Case* has no application with respect to A's interest (Recommendation 1). A retains a $1000

interest in that fund secured by a lien (Recommendation 2). T then withdraws another $500. The balance of the account is now $500. A's interest in that fund has been reduced to $500 (Recommendation 3), although if T's withdrawals or their proceeds can be traced or identified, A's lien or charge persists against them (Recommendation 2).

Example 2:

T, a trustee, deposits $1000 he holds in trust for A, into his own account. At that time his account has no money in it. T withdraws $500. A's lien or charge on the fund (Recommendation 2) is reduced to $500 (Recommendation 3). T deposits $1000 he holds in trust for B into the account. Subsequently T withdraws $700. The rule in *Clayton's Case* does not apply to determine the interests of A and B in the fund (Recommendation 1). Before T's withdrawal of $700, A had a $500 interest in the fund. Accordingly A was entitled to a 500/1500 portion of the fund (Recommendation 6). B was entitled to 1000/1500. The balance of the fund was reduced by $700. That shortfall is shared between competing claimants *pari passu* (Recommendation 6). A's interest is reduced by 500/1500 of $700 or $233. B's interest is reduced by 1000/1500 of $700 or $466. A is now entitled to a lien or charge of $267 on the fund, and B is entitled to a lien or charge of $534. An additional $1 has crept into the figures by rounding off the arithmetic calculations, but the example demonstrates how these proposals should function.

We received some comment that preferred the first approach, *pari passu* sharing based upon original entitlement. That conclusion was favoured by our commentators who suggested that tracing should depend upon relationship and course of conduct rather than identifiability of property.

In some cases, the first approach may arrive at commendable results. For example, a nephew, A, is entrusted with money by his two aunts, B and C. If he receives that money at the same time, deposits it in an account, and then uses some of it for his own purposes, each aunt shares in the remaining fund in accordance with her original interest.If A receives Aunt B's money Monday morning, and buys a car with it, and Aunt C's money Monday afternoon, and spends that on an evening of entertainment, under the second approach, only Aunt B can trace. The difference in result is due only to an accident of timing, and may appear to be as unfair and unsatisfactory as the rule in *Clayton's Case*.

We recognize that, in some Cases, claimants will be entitled to differing rights. These results flow from retaining the property basis of tracing.

Suppose, however, that A deposits his Aunt B's money in his account and invests most of that wisely. A then steals money from his employer D, and deposits that money in the same account where it is mixed with Aunt B's remaining money. A withdraws the balance of the account, and spends the money foolishly, so that no product of it can be traced. Should D be able to trace into Aunt B's investments? We think that result would be unjust.

Consequently, the Commission has concluded, the second approach to determining entitlement to a mixed fund should be adopted. There may, however, be circumstances where the courts should be entitled to depart from that approach and divide a mixed fund among claimants in accordance with their original interests.
That may be the fairest approach where, for example:

(1) separate accounts are treated as one account;

(2) it is intended to treat a number of subscriptions as a mixed fund, but instead the subscriptions are used separately;

(3) there are a large number of claimants, each with minor interests in a mixed fund.

Examples are useful to understand these various circumstances:

Example 1: The Xantrex Example

A company solicited funds for investment through two subsidiary companies. Funds were transferred among the various companies. Upon liquidation, one subsidiary company had sufficient funds to repay its investors. The other subsidiary company was unable to repay its investors.

A reasonable approach might be to divide the assets of the two subsidiaries pari passu among all the investors. In the Working Paper we rejected this approach.

> Is this one instance where the rules governing tracing carry the remedy too far? Where separate but similar classes are treated as one class and are similarly prejudiced by the acts of a fiduciary should they share *pari passu*? While this result may be desirable, we think that it does too much harm to the basic premises upon which the law is built, notwithstanding the peculiarities that arise from regarding rights as either personal or proprietary. In our opinion, the classes must be regarded separately. The basis of a proprietary remedy is that a claimant can point to an asset in which his money or property notionally persists. That proposition is directly counter to treating separate classes as one class.

Example 2: The Re Winnipeg Mortgage Exchange Example

In this case, investors with a mortgage broker advanced funds which were to be invested in mortgages. The Manitoba Court of Appeal held that the investors had all intended to be on the same footing, and therefore all shared in the "good" mortgages, notwithstanding that equitable principles of tracing would have permitted various investors to locate their monies in specific mortgages.

Example 3: The Re Saskatchewan General Trusts Corp. Example

Trust funds were deposited in a general account, from which current expenses were paid. The proceeds of the trust funds were traceable, but the specific trusts contributing the funds were not identifiable. The trust creditors agreed to share *pari passu* in accordance with their original interests, and that agreement was approved by court order.

In some circumstances, due to the number of claimants, or the absence of evidence to identify proceeds, or myriad minor transactions on a fund, the approach adopted in the Working Paper may result in a tedious series of arithmetic calculations to determine the priorities among the claimants. In these kinds of circumstances, dividing a common asset base among claimants according to their original entitlement might be desirable.

While there would be some difficulty in defining when the courts might depart from the usual rules governing tracing, it would be unfortunate to fetter the courts in circumstances where they currently appear to enjoy some flexibility in dividing property among a number of competing claimants. On the other hand, "fairness" is, in these circumstances, a subjective question. Dividing a mixed fund by reference to the altered interests of claimants is "fair." That approach is based upon determining what portion of a claimant's property remains in a fund, without resort to fictions, so far as that is possible. No injustice flows from requiring that approach in all circumstances where tracing is currently available. That approach also has the advantage of certainty.

For those reasons we have concluded that the courts should not have a jurisdiction to depart from pari passu division based upon the altered entitlement of the claimants. This principle should apply in the absence of contrary prior agreement among the claimants.

If the claimants had previously agreed to share shortfalls or profits to the fund on some other basis, their agreement should govern. In part, that is why it would appear to be fair to divide equally the proceeds of the money entrusted to the nephew by his aunts in the example above. Because of their relationship to each other and to the nephew, neither aunt may wish to assert priority over the other. Often relatives will have implicitly agreed, in these circumstances, to share profit and loss equally. In more formal arrangements, such as partnerships, syndicates and other kinds of joint ventures, the parties will have expressly agreed to a precise formula for dividing profits and loss. That appears to be the basis of the decision of the Manitoba Court of Appeal decision in *Re Winnipeg Mortgage Exchange*. The revised rules of tracing should not affect an express or implied agreement to the contrary. Legislation enacting our recommendations should ensure that rights to contribution or an accounting are not affected.

The Commission recommends that:

7. *Nothing in [the general rules] interferes with the enforcement of any right to contribution, apportionment or an accounting among competing claimants to one or more funds based on a common intention of the claimants with respect to the distribution of profits and losses.*

(e) Volunteers

Lastly, we must consider the case of a volunteer who holds the fund. If his monies are mixed with that fund, he should be treated as any claimant, entitled to share pari passu to the proportion of his monies in the fund. If, however, money is withdrawn from the fund and used for the benefit of the volunteer or any person with an interest in the fund, that person's interest should be reduced by that amount, subject to the defence of change of position. With respect to a claimant, that is the effect of the current law. With respect to a volunteer, *Re Diplock* holds that money withdrawn from a fund and used for the benefit of a volunteer does not necessarily reduce the volunteer's interest in the fund. Whether the volunteer's interest is reduced depends on the rule in *Clayton's Case*. Moreover, in many cases other claimants of the fund are not permitted to trace withdrawals used for the benefit of a volunteer. There should be no blanket protection for volunteers, although they should be entitled to resist other claims by raising the defence of change of position. These anomalies should be corrected by reform legislation.

Professor Fridman suggests that further consideration should be given to the interests of a volunteer who innocently receives a fund:

> However, there may be legitimate reasons of policy, if not of principle, to differentiate volunteers like the charities in *Diplock* from other volunteers who may have actual or constructive notice of the rights or interests of true owners with respect to money in a particular fund. On this aspect of the Commission's Working Paper, therefore, there is room for greater debate and argument than on many of the others. Admittedly, the innocent volunteer may not acquire legal, or even equitable, rights in the money which he receives and uses. That, in itself, may not be a sufficiently powerful reason for saying that such volunteer is completely vulnerable to the later claims of a legitimate claimant. Even with the aid of the defence of change of position, such a volunteer may be placed in an awkward situation, as were the charities in *Re Diplock*.
>
> To this reviewer, at any rate, the case made out by the Commission is not as persuasive as it is with regard to the rule in *Clayton's Case* generally. Some rethinking of this issue may be desirable by the Commission itself and more especially, by others, such as charitable institutions and those who give them legal advice.

In part, Professor Fridman's concern derives from the uncertain ambit of the defence of change of position. As we mentioned earlier, while the validity of the defence has been recognized, the principles which govern it are, as yet, unformed. In theory, the defence should apply where the recipient of property either uses it so as to reduce the benefit to him, or is induced by its receipt to make an extraordinary expenditure, so that to repay it would leave the recipient worse off than before receipt of the benefit. In theory, therefore, the defence should adequately protect the interests of innocent volunteers. We are content to leave development of the defence to the common law.

We think that legislation should also confirm what is to occur when a person receives property from a fund in excess of any interest he had in the fund. In that case, the recipient is a volunteer. If he uses the property, conceivably he receives some benefit from it. Subject to the defence of change of position, he should be required to account for that benefit, if the property is no longer traceable.

The Commission recommends that:

8. Subject to the defence of change of position, the position of an innocent volunteer of a fund with an interest in that fund should not differ from that of any other person with an interest in the fund.

9. Subject to the defence of change of position, a person who has been benefitted by the fund, should account for that portion of the benefit in excess of the maximum interest he had in the fund.

Removing the present distinctions between volunteers of a fund and other persons with interests in that fund can be accomplished by enacting legislation comparable to the following:

(a) Monies withdrawn from the fund used for the benefit of a person with an interest in the fund reduce that person's interest, notwithstanding that the person is a volunteer of the fund.

(b) Subject to the defence of change of position,

(i) if money is withdrawn from a fund and used for the benefit of a volunteer, and is traceable or identifiable, the interests of other persons in the fund persist against those proceeds of the fund;

(ii) a person must account for any benefit he has received in excess of his maximum interest in the fund.

(f) Effect on Other Proprietary Remedies

We received comments that questioned the desirability of reform in this area. Legislation confirming aspects of proprietary rights, it was suggested, might adversely affect development of the law generally in the context of proprietary remedies.

Our critics had in mind, in general, the developing principles of unjust enrichment, and in particular, the remedial constructive trust, a remedy the validity of which has only been recognized recently. Traditionally, in certain circumstances, a person wrongfully deprived of his property was entitled to a constructive trust, equitable lien or equitable charge against its proceeds, provided they could be traced. A remedial constructive trust provides a person with a proprietary remedy to enforce a right which is not necessarily proprietary. The two Supreme Court of Canada decisions where this remedy was applied involved property disputes between, in one case, a husband and wife, and in another, common law spouses. In each case, one spouse had made contributions in various ways which benefitted the other spouse who was enabled to acquire property. When the relationship broke down, the spouse who was not on title asserted a right to share in the property. According to traditional principles, since there had been no direct contribution to the acquisition of the property, and no implied or express agreement that the property was held on behalf of both spouses, the spouse who was not on title had no right to share in the property. To avoid unjustly enriching the spouse in whose name the property was held, the court found that he was a constructive trustee of the property for the other spouse.

It is difficult to imagine circumstances in which our recommendations will deter the courts from preventing unjust enrichment by imposing a remedial constructive trust. Our recommendations clarify when a proprietary interest may be traced, and how that proprietary interest is identified if mixed in a

fund or exchanged for other property. Nothing in the recommendations impairs the use of a remedial constructive trust. An example is useful to understand this point.

A trustee, T, deposits money he holds in trust for A, B and C in a bank account. The deposits are made successively. Money is withdrawn from the account. Under the current law, those withdrawals are deemed to be made first from A's money, then B's, then C's (first in, first out). The withdrawals exhaust the interests of A and B in the fund. A third party who asserts rights against the fund by way of a remedial constructive trust, is in competition with C. A remedial constructive trust will only be imposed if the courts find that if C receives the return of his money, he would be unjustly enriched at the expense of the third party. Under our recommendations, withdrawals are apportioned among A, B and C's interests *pari passu*. A third party who asserts rights against the fund by way of a remedial constructive trust will be in competition with A, B and C. That will not prevent the courts from imposing a constructive trust in favour of a third party if recognizing A, B and C's interests in the fund would unjustly enrich them at the third party's expense.

In the example, we have assumed that a third party might be able to assert a constructive trust against the fund, but we have not described when that might occur. We are at a loss to imagine such a circumstance. Perhaps A, B or C obtained their money from the third party pursuant to a voidable transaction, or in some other way the third party has a claim in restitution to the monies. It is difficult to imagine any situation where a claim by a third party against the trustee would cause a court to give the third party priority over claimants with a proprietary interest in a mixed fund. We do not find merit in the criticism that legislation clarifying the operation of equitable principles defining proprietary interests will adversely affect the development of the law generally in the context of proprietary remedies.

These critics appear to be suggesting that redefining priorities among undoubted proprietary interests will prevent the courts from recognizing the equality or superiority of a proprietary remedy in aid of a personal right based upon restitutionary principles. That does not follow. Under the current law the competition will be between a proprietary holder and a person who asserts in *personam* rights. Adjusting the relationship between several proprietary holders is irrelevant with respect to that dispute.

A related concern, which results from a novel suggestion, recently published, should be addressed. Professor Klippert asserts that:

> The equitable lien, like the constructive trust, has become another type of equitable remedy (detached from proprietary rights) imposed to prevent particular cases of unjust enrichment.

Our recommendations confine the equitable lien to its proprietary foundation. We do not necessarily agree that the equitable lien has been "detached from proprietary rights." So far as we are aware, it has not been used to remedy unjust enrichment by protecting a personal right. In any event, it is irrelevant whether the equitable lien has, or will develop in this way. Our recommendation to provide a statutory remedy in circumstances where a person has been deprived of property is unlikely to affect the development of the equitable lien in equity to remedy unjust enrichment by protecting a personal right.

(g) An Example

The following example demonstrates how these recommendations, if enacted, would work:

> Assume that A steals from B the sum of $10,000. A places that money in his bank account which has a balance of $10,000. A withdraws from that account $15,000, $5,000 of which he spends in riotous living. $10,000 of that money is used to buy a car. A is also a trustee for C. He deposits $10,000 of money he holds in trust for C into that bank account. A then withdraws $15,000, exhausting his account, $5,000 of which is spent, and the other $10,000 is given to D. D places that sum in his own bank account and then deposits $10,000 of his own money. D withdraws $15,000 and discharges a mortgage registered against his home.

Under the current law:

1. B has only personal rights and remedies against A. He cannot look to the bank account or any traceable product of that account.

2. C, in equity, can trace into A's bank account, and through it to the gift to D, a volunteer. C has a lien for $10,000 against D's bank account. Only $5,000 remains in that account. The rule in *Clayton's Case* determines that C's money has been withdrawn. Only D's money notionally remains. C cannot trace into D's home.

Under our recommendations:

1. B would be entitled to a lien against A's account, and against the car purchased with funds from that account (Recommendation 2). B's lien is for $10,000 and he may pursue his remedy against the car and the account"... to the extent that pursuit of one remedy produces satisfaction of the plaintiff's interest other concurrent remedies abate, for the plaintiff cannot, of course, recover his loss twice over."

   A claimant whose remedies may be asserted against, for example, different chattels should not be permitted to exercise those remedies to the prejudice of a claimant who may only be entitled to look to one chattel. In such a case the equitable doctrine of marshalling should apply. Snell (*Principles of Equity*, 27th ed., 1973) describes that doctrine as follows (at 404):

Where there are two creditors of the same debtor, one creditor having a right to resort to two funds of the debtor for payment of his debt, and the other a right to resort to one fund only, the court will so "marshal" or arrange the funds that both creditors are paid as far as possible. "A person having resort to two funds shall not by his choice disappoint another, having one only." Though the doctrine has several applications, marshalling as between mortgagees is perhaps the most usual. If, for instance, a person having two estates, Blackacre and Whiteacre, mortgages both estates to A, and afterwards mortgages only Blackacre to B, either with or without notice of A's mortgage, the proper course is for A to realise his debt first out of Whiteacre and to take only the balance out of Blackacre, in order to leave as much as possible of Blackacre to satisfy B. The doctrine of marshalling is not allowed to prejudice the first mortgagee, however, and A can therefore realise his securities as he pleases; but if he pays himself out of Blackacre, B is allowed to resort to Whiteacre to the extent to which Blackacre has been exhausted by A, and to have the same priority against Whiteacre as A had. (Recommendations 2 and 8). If the car cannot be found, B can only look to the bank account. The minimum balance of the account before the deposit of C's money was $5,000. B's lien on the account is therefore reduced to $5,000 (Recommendation 3). B may trace into the gift to D. His lien extends to D's bank account and to D's home (Recommendation 8).

2. C's rights are exactly as under the current law, except that his $10,000 lien extends to D's bank acount and to D's home as well. B, C and D share the account *pari passu* (Recommendation 6), subject to D's obligation to account for the benefit he has received from that account (Recommendation 9).

3. D is entitled to a $10,000 lien on his account. However, he has had the benefit of $15,000 from the account. Therefore, his lien on the account is extinguished (Recommendation 8). Moreover, he is accountable for $5,000 (Recommendation 9).

4. A's account is exhausted. $5,000 remains in D's account, and $5,000 notionally persists in D's home. Therefore, $10,000 persists in assets. B is entitled to $5,000. C is entitled to $10,000. The sum remaining will not satisfy their respective interests. B is entitled to 1/3 of the bank account and C is entitled to 2/3 (Recommendation 6). Their interests persist against the $5,000 for which D is accountable (Recommendation 9), and are secured by lien against his home (Recommendations 2 and 8).

CHAPTER VI CONCLUSION

We have concluded that legislation based upon our recommendations will achieve fairer results than those which presently ensue from the use of the rule in *Clayton's Case*. While the focus of this Report has been that rule, we have found it necessary to explore its application in the wider context of legal and equitable proprietary remedies. From this examination we have noted a number of anomalies that

exist in this area of the law, and some of our recommendations are directed toward resolving those anomalies.

It should be observed that abolishing the rule in *Clayton's Case* and requiring claimants to share *pari passu* will in itself have beneficial consequences. Our recommendations with respect to tracing at law or in equity, we have concluded, promote necessary reforms. Nevertheless, they are ancillary to the question of whether *Clayton's Case* should be abolished.

A. List of Recommendations

The following is a list of recommendations made in this Report. Legislation should be enacted to implement the principles embodied in these recommendations.

1. *The presumption in* Clayton's Case *should not apply to ascertain the order in which monies are drawn from an account for the purposes of the equitable doctrine of tracing.*

2. *(a) A fiduciary relationship should not be necessary to found an equitable tracing remedy.*

   (b) A person who, whether owed fiduciary duties or not, has been wrongfully deprived of property, in tracing into a mixed fund is entitled to an equitable lien against the proceeds of that property, notwithstanding that it has been mixed with other property.

3. *A person with an interest in a fund should only be entitled to the lesser of the value of his interest and the minimum balance of that fund.*

4. *Unappropriated deposits of a wrongdoer's own money should restore a person's interest in a fund that has been diminished by the wrongdoer.*

5. *Profit earned by and added to a fund should be appropriated to a person's interest in a fund in the proportion that that person's interest bears to the whole of the fund.*

6. *If there is more than one claimant to the fund, they should share* pari passu *in the fund or in any traceable or identifiable proceeds of the fund. [The mechanics of* pari passu *sharing are set out in the text at pages 8081 and in the collected draft legislation in the next section.)*

7. *Nothing in [the general rules] interferes with the enforcement of any right to contribution, apportionment or an accounting among competing claimants to one or more funds based on a common intention of the claimants with respect to the distribution of profits and losses.*

8. *Subject to the defence of change of position, the position of an innocent volunteer of a fund with an interest in that fund should not differ from that of any other person with an interest in the fund.*

9. *Subject to the defence of change of position, a person who has been benefited by the fund should account for that portion of the benefit in excess of the maximum interest he had in the fund.*

B. Legislation

Our recommendations are framed with respect to the general principles we think should be reformed or codified. However, we also thought it useful to discuss legislative approaches to enacting these recommendations and in the preceding text we have formulated draft legislation. That draft legislation is

not intended as a model for legislative action. It is designed to place in context the various recommendations we have made. For convenience, we collect that draft legislation together here, and would invite particular attention to the terms we have used. We mentioned earlier that terms like "interest" and "proceeds" might be precisely defined, and identified possible approaches that might be taken in that respect. Other terms which might be defined include "fund" and "equitable lien."

1. Except to determine rights between a debtor and his creditor, there is no rule or presumption that withdrawals from a fund are appropriated against deposits in the order in which they occur.

2. A person deprived of property in which he has an interest is entitled, to the extent of that interest, to

   (i) an equitable lien on the proceeds of that property, or
   (ii) an equitable lien on a fund in which his property or its proceeds have been comingled.

3. A person's interest in a fund is determined by the value of his interest in that property or in its proceeds mixed in that fund, except that

   (i) if the balance of the fund falls below the person's interest, his interest is diminished by the shortfall;
   (ii) additions to the fund by the wrongdoer, not attributable or expressly appropriated to another interest, are deemed to restore the person's interest.

4. Profits earned by, or by the use of, the fund or part of it, and added to the fund, increase the person's interest in the fund by the proportionate share of those profits his interest bore to the whole of the fund.

5. If there are two or more persons with interests in a fund, the amount of any shortfall from or accretion to the fund which would have affected their respective interests, and which is not appropriated to a specific interest or interests, is divided and attributed to their respective interests in such proportion as their respective interests bore to the sum of those interests before the shortfall or accretion occurred.

6. (a) Monies withdrawn from the fund used for the benefit of a person with an interest in the fund reduce that person's interest, notwithstanding that the person is a volunteer of the fund.

   (b) Subject to the defence of change of position,

      (i) if money is withdrawn from a fund and used for the benefit of a volunteer, and is traceable or identifiable, the interests of claimants in the fund persist against those proceeds of the fund.
      (ii) a person must account for any benefit he has received in excess of his maximum interest in the fund.

7. Nothing in [the general rules] interferes with the enforcement of any right to contribution, apportionment or an accounting among competing claimants to one or more funds based on a common intention of the claimants with respect to the distribution of profits and losses.

C. Acknowledgements

We wish to express our appreciation to all those who took the time to consider the Working Paper, and offered us their comments and suggestions, either through correspondence or publication. The submissions we received assisted us considerably and provided much food for thought.

We also wish to acknowledge the contribution of two former members of the Commission who played an important role in this project: Messrs. Peter Fraser and Kenneth C. Mackenzie. Both participated in the development of the Working Paper and Mr. Mackenzie, whose appointment as a Commissioner expired only shortly before this Report was finalized, assisted in the development of our recommendations.

Finally, we wish to express our gratitude to Thomas G. Anderson, Counsel to the Commission. Mr. Anderson was responsible for the research upon which our recommendations are based and, subject to direction from the Commission, drafted both the Working Paper and this Report.

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Commission member Ronald I. Cheffins did not participate in the making of this Report.

September 22, 1983

APPENDIX

American Restatement of the Law of Restitution, ss. 202215

§ 202. Conscious Wrongdoer

Where a person wrongfully disposes of property of another knowing that the disposition is wrongful and acquires in exchange other property, the other is entitled at his option to enforce either

(a) a constructive trust of the property so acquired, or
(b) an equitable lien upon it to secure his claim for reimbursement from the wrongdoer.

§ 203. Innocent Converter

Where a person converts the property of another without notice of the facts which make him a converter and being still without such notice exchanges it for other property, the other is entitled to an equitable lien upon the property received in exchange to secure his claim for restitution, but is not entitled to enforce a constructive trust of the property.

§ 204. Gratuitous Transferee

Where a person receives the title to property of which another has the beneficial interest without notice of the other's interest but without paying value, and being still without such notice exchanges it for other property, he is under a duty either

(a) to surrender the property which he acquired in exchange, or, at his option,
(b) to pay the value of the property which he acquired in exchange being subject to an equitable lien for such payment.

§ 205. Accountability for Direct Product

Where a person receives property for which he is accountable to another, he is accountable for any direct product which he receives from the property.

§ 206. Improvements upon Wrongdoer's Property

Where a person wrongfully uses property of another in making improvements upon property already owned by the wrongdoer, the other is entitled to an equitable lien but is not entitled to enforce a constructive trust.

§ 207. Discharging Obligation or Lien

Where a person wrongfully uses property of another in discharging an obligation of the wrongdoer to a third person or a lien held by a third person upon his property, the other is entitled to be subrogated to the rights which the third person had before the obligation or lien was discharged.

§ 208. Liabilities of Third Persons

(1) Where a person wrongfully disposes of property of another knowing that the disposition is wrongful and in exchange therefor other property is transferred to a third person, the other can enforce a constructive trust or an equitable lien upon the property, unless the third person is a bona fide purchaser.

(2) Where a person wrongfully uses property of another in making improvements upon property of a third person, the other can enforce an equitable lien upon the property, unless the third person is a bona fide purchaser, but he is not entitled to enforce a constructive trust.

(3) Where a person wrongfully uses property of another in discharging an obligation of a third person or a lien upon property of a third person, the other is entitled to be subrogated to the rights which the creditor or lienholder had before the debt or lien was discharged, unless the third person is a bona fide purchaser.

§ 209. Mingling with Funds of Wrongdoer

Where a person wrongfully mingles money of another with money of his own, the other is entitled to obtain reimbursement out of the fund.

§ 210. Effect of Acquisition of Other Property with Mingled Funds

(1) Where a person wrongfully mingles money of another with money of his own and with the mingled fund acquires property, the other is entitled to an equitable lien upon the property to secure his claim for reimbursement.

(2) If the wrongdoer knew that he was acting wrongfully, the other is entitled at his option to a share of the property in such proportion as his money bore to the whole amount of the fund.

§ 211. Effect of Withdrawals from Mingled Fund

(1) Where a person wrongfully mingles money of another with money of his own and subsequently makes withdrawals from the mingled fund, the other is entitled to an equitable lien upon the part which remains and the part which is withdrawn or upon their product, except as stated in Subsection (3).

(2) If the wrongdoer knew that he was acting wrongfully, the other is entitled at his option to a proportionate share both of the part which remains and of the part which is withdrawn or of their product, except as stated in Subsection (3).

(3) Where the wrongdoer has effectively separated the money of the other from his own money, the other is entitled to, and only to, his own money or its product.

§ 212. Effect of Withdrawals and Subsequent Additions

Where a person wrongfully mingles money of another with money of his own and makes withdrawals from the mingled fund and dissipates the money so withdrawn, and subsequently adds money of his own to the fund, the other can enforce an equitable lien upon the fund only for the amount of the lowest intermediate balance, unless

(a) the fund or a part of it earns a profit, or
(b) the subsequent additions were made by way of restitution.

§ 213. Mingling Money of Several Persons

(1) Except as stated in Subsection (2), where a person wrongfully mingles money of two or more persons, each of them is entitled to share in the mingled fund or in property acquired with the fund, in such proportion as his money bore to the whole amount of the fund.

(2) Where the wrongdoer has effectively separated the money of one of the claimants, that claimant is entitled to, and only to, his own money or its product.

§ 214. Mingling Things Other Than Money

The rules stated in §§ 209213 are applicable where a person wrongfully mingles things other than money.

§ 215. Necessity of Tracing Property

(1) Except as stated in subsection (2), where a person wrongfully disposes of the property of another but the property cannot be traced into any product, the other has merely a personal claim against the wrongdoer and cannot enforce a constructive trust or lien upon any part of the wrongdoer's property.

(2) Where a broker wrongfully disposes of the securities of a customer, the customer is entitled to claim in substitution therefor securities of the same issue owned by the broker.