Bianca Kabel (BK):
Good evening everyone. We might kick off there, I see that it is 5.30.

Welcome. My name is Bianca Kabel. I am a barrister here at Level Twenty Seven Chambers. We are delighted to have you here with us this evening. We understand it is a particularly busy time of year for you all. So we are especially grateful to you for joining us. We have an excellent presentation for you tonight from two subject matter experts, Jaamae Hafeez-Baig and Jordan English. They are co-authors of the book 'The Law of Tracing' which is to be published by the Federation Press next year in December.

Jaamae, to begin, is a very talented Junior barrister here at Level Twenty Seven Chambers. He most recently returned to Australia from the University of Oxford where he completed his Bachelor of Civil Law, the BCL, with Distinction.

We are also very excited to welcome Jordan who currently teaches Contracts and Trusts at the University of Oxford. He is undertaking his DPhil there as well, which is on the discharge of contractual obligations. He also undertakes research in all areas of private law. Before going to Oxford, Jordan studied locally here in Queensland at the University of Queensland, was a solicitor at an international law firm and the Associate to Justice James Edelman at the High Court.

Can I begin by thanking both Jaamae and Jordan for their time this evening and hand over to Jordan to kick us off.

Jordan English (JE): Thank you very much Bianca for that kind introduction. And thank you to Tamara and Level Twenty Seven Chambers for obviously hosting us this evening.

The core focus of our presentation today is going to be on the equitable rules of tracing. That is represented on the second half of the slide [3] there. But first, what we are going to need to do is to look at some of the foundational concepts. The reason that we are doing this is because, in our own opinion, what has made tracing so difficult to understand, to conceptualise, is that we don't always have a very clear idea of the concepts which are in play.

Now, we are also going to very briefly mentioned common law tracing, which is that second part of the slide [3] you can see there. The reason I say we are going to briefly consider common law trading is because practically it is not all that significant. As a matter of principle, Jaamae and I have both argued in print that common law tracing should not be recognised at all.

We also have some slides at the end which have been greyed out and we have included them for reference only. I have been informed that the slides have not been sent out yet, however, a recording of this webinar and the slides will be sent out tomorrow so there is no need to furiously take notes as we go along.

Of course, if there are any questions on those aspects please do feel free to send us an email, and our emails are being included on the slides. I understand we will be taking questions at the end. So if you do have questions throughout throw them in the chat, and Jaamae and I will be able to take them at the end.

KEY CONCEPTS OF THE LAW OF TRACING

JE: So then, turning to the key concepts, and one of the first concepts that we need to clarify is the distinction between legal and ethical, proprietary rights. And in particular, what we want to reject is a common misconception. The misconception is that subject to one qualification, legal proprietary rights and equitable proprietary rights are the same in nature and in the way that they behave. That qualification, as you can see on the slide [4], is that equitable proprietary rights are weaker and more fragile because they are subject to the bona fide purchase of defence.

Now on this view, which we have called the 'mirror image view', equitable proprietary rights are treated separately from legal proprietary rights only because of the historical divide between equity and the common law. We are trying to represent on the next slide [5], what this might look like diagrammatically. And so, you are given an example. It is common to think of in relation to land of the legal title and the equitable title, and to use those two terms to refer to the different forms of ownership. While you might say that A is the owner of blackacre law B is the owner of blackacre in equity. In other words, we think of both as having a right to blackacre which is just simply that one is recognised in common law one is recognised in equity.

On this view, the common law and equity appear to contradict each other. But as Maitland once said, imagine what would happen if this were true. It would mean that within one legal system we have two jurisdictions which completely contradict each other. This is perhaps even more pronounced where you have two judicature acts which have merged the courts of equity in the common law. So, you have the same court on the one hand and saying that A is the owner, and on the other hand B is the owner. Fortunately, we do not have that system and legal and equitable proprietary rights are not simply mirror images of each other, and they don't have the same incidence nor do they behave in the same way. As you can see on the slide [6], the High Court in the *Linter Textile* case where we use the word such as 'ownership' in relation to equity or beneficial ownership, we need to be clear the use of the word 'owner' does not mean that the person has *all* the same rights they would have if they were the legal owner. It is essential not to forget, and this is the key takeaway, that when we use words like 'ownership' and 'equity' we are using them in a very different sense from that which they use in common law.

Mohammud Jaamae Hafeez-Baig (JH): If we know that equitable proprietary rights are not the same as legal proprietary rights, the question is, what are they? We think that the easiest way to answer this question is to look at really the archetypal equitable proprietary right, which is the rights that a beneficiary has under a trust. There has been a long running debate between two camps over the nature of those rights, and two classic views have been put forward. We will go through these, but as you will see, we think that neither view is completely correct, that the answer is actually somewhere in the middle. We put forward a third, and we would say better, view.

The first classic answer, which has been given to the question, what is the nature of a beneficiary's rights under a trust is what we call the 'proprietary view'. The essence of that view is the creation of a trust gives the beneficiary a right to the property, legal title to which is held on trust. We have tried to represent this diagrammatically on the slide [8]. We have a trustee who holds legal title to blackacre. We can see there that the beneficiary has a right to blackacre. But we know that this view cannot be right because the beneficiary, as a matter of positive law, does not have the sorts of rights we would expect the beneficiary to have if they did have a right to blackacre. And so, the beneficiary here has no right to possession of blackacre. If a third party interferes with that possession they can't sue.

The second view, which we call the 'obligational of view', says that the creation of a trust imposes particular duties on the trustee and gives the beneficiary only corresponding personal rights against the trustee. In the diagram on the slide [9], you can see that again the trustee has legal title to blackacre. But this time, the beneficiary only has personal rights against the trustee, they have no rights to blackacre itself. Once again, we know that this view cannot be right because the beneficiary's rights, as a matter of positive law, do have some proprietary effect. We know this because the beneficiary's rights can, in a limited sense, bind third parties, and so they cannot be purely personal rights against the trustee.

For example, if legal title to trust property is transferred to a third party who knows that it is trust property and therefore cannot make up the bona fide purchaser defence, the beneficiary can bring an equitable proprietary claim against the third party. Therefore, because the beneficiary's rights have some proprietary effect against third parties, we know that they cannot be purely personal rights against the trustee.

That takes us to our view, which is that both of those views are partly correct. And we say the equitable proprietary rights are rights against rights. That is a view which has been put forward by Professor McFarlane and Professor Stevens, and Justice Edelman writing extra judicially, in the articles that we have cited on the slide [10]. Under this approach, the beneficiary's rights under a trust are rights against the trustee's legal title to the trust property, and those equitable proprietary rights require the trustee to hold their legal title, that is their legal rights to the trust property, for the beneficiary's benefit, and more specifically, in accordance with the terms of the trust. Importantly, this approach explains quite neatly, why it is that equitable proprietary rights can have that limited proprietary effect against third parties, to which I referred earlier. What binds the third party is the receipt of the legal title itself. And so, we see a neat diversion between what makes a third party liable for the unauthorised receipt of property at law and what makes them liable for the unauthorised receipt of property in equity. At law, third parties become liable when they interfere with the physical thing itself. But in equity, they become liable when they receive legal rights against which a beneficiary has equitable proprietary rights.

This view, importantly, is entirely consistent with the Australian case law, in our view. On the screen [slide 11], we have got a classic quote from Justice Hope in the *DKLR* [*Holding Co (No 2) Ltd v Commissioner of Stamp Duty*] decision. His Honour explains that the rights of the beneficiary is the right to compel the legal owner to hold and use the rights which the law gives him, that is the trustees legal rights, in accordance with the equitable obligations imposed on him.

Similarly, on this slide [12], we have a quote from another classic case *Re Transphere* [*Pty Ltd*] where Justice McLelland explains that the beneficiaries of right is not grafted onto the trustee's legal estate and is not carved out of it. In the recent decision of the High Court in *Carter Holt Harvey* [*Harvey Woodproducts Australia Pty Ltd v The Commonwealth*] the plurality goes on to explain that it is not grafted onto the trustee's legal title as a restriction on the manner in which the trustee may deal with the trust assets. The same point was repeated earlier this year in the rejerred decision by four Justices of the High Court.

For the sake of completeness, on this slide [14], we have listed a number of Queensland cases which make the same point. We say that the rights against rights view is not only the better view as a matter of principle, it is also consistent with the positive law.

JE: So, the combination of what we have called foundation one and foundation two is that while we commonly speak of the trustee as holding assets or holding property on trust, strictly speaking what a trustee holds on trust rights are rights, the trustee holds rights on trust. Now, often these rights will be legal rights, but as in the case of a sub-trust the rights to hold on trust may in fact be equitable rights. Indeed, the benefit of this explanation is it can help us understand why it is that a bank account, which is a personal right, as against the bank, can also be held on trust, because as we said, the trustee holds rights on trust.

And so it is, and this is the second point on the slide [15], therefore inaccurate to speak of a trustee holding land on trust for a beneficiary. Rather, what the trustee holds on trust is the legal title to the land. That is what is the subject matter of trust. As you can see from the slide [13], in the *Carter Holt* decision, the plurality part. They make this very point, the expression trust assets is simply shorthand for the rights which are held on trust by the trustee.

WHAT IS TRACING?

JE: Now 15 slides later, we can finally begin to discuss what is tracing. A distinction is sometimes made in the cases in the literature between following and tracing. To take it from the decision of *Foskett v McKeown*, Lord Miller says that following is a process of following the same asset as it moves from hand to hand. Whereas tracing is a process of identifying a new asset as a substitute for the old.

In light of everything we have just said, we probably need to retweak this slightly. I think our view would be to say following is the exercise of locating not necessarily the physical thing or the physical asset but rather the subject matter of a right. Depending upon whether the right is legal or equitable, the subject matter of that right may be the thing itself, or it may be a legal right.

To give an example, and to help conceptualise this, if someone steals my motorbike, I retain legal title to the motorbike. That theft does not give them the legal title which I held. In that case, the subject matter of my legal title is the motorbike itself, that is a subject matter of the right. And so, following is then just simply the process of trying to identify where it is that my motorbike has gone. Once I can locate my motorbike out there in the world somewhere, I can claim it. The reason I can claim it is because I still own it, I still got a legal right to the motorbike. But let us suppose at this time that title to the motorbike is held on trust, and the trustee in breach of trust conveys it to a third party. In this case the subject matter of my right is now the legal title to the motorbike, it is not the actual motorbike itself. And so to speak of following the motorbike in this scenario is really the speaker following the legal title to the motorbike as it moves from hand to hand.

Now tracing is then a different process. When the trustee conveyed legal title to the motorbike, the example where they held it on trust to a third party, the trustee may have received cash in exchange. Now tracing allows me to say to the trustee, you were previously required to hold title to the motorbike on trust to me, you are now no longer able to do that. What you must do is hold the rights to the cash on trust to me. In other words, and this is the second last point of the slide, tracing is concerned with where one set of rights, the substitute rights, can stand in the place of another set of rights, the original rights, for the purposes of various claims we may seek to bring.

The final point to recognise on this slide [21] is that it is often said that tracing is neither a claim nor remedy. This is repeated in almost every decision which talks about tracing. And we had to spend some time in the book actually trying to figure out what this phrase means and how best to explain it. I think the position that we have come to is that the most distinct way to put this proposition is to say this, which is that the rights generated by tracing against the substitute rights form but one part of substratum of any potential claim, which if laid out in combination with additional facts, may then entitle the claimant or the plaintiff to a particular remedy. As a result, it is therefore strictly speaking incorrect to speak about tracing claims or tracing remedies because those two things are logically distinct.

So, the next question is when we are speaking about tracing, what is it that we are tracing? What do we trace? Prof. Lionel Smith was one of the first people to offer a comprehensive answer to this question. And his approach was adopted in large part by the House of Lords in the 2001 *Foskett v McKeown* decision.

What Lionel Smith suggested is that when we trace we are tracing the value inherent in assets, or the value in which he is of right, as it moves from one asset to another. The idea is, when we have a substitution, this swap, we can identify the value simply in a new form in the new asset. As I mentioned, this is the view which has been adopted by *Foskett*. The problem with this view is that, however one wants to conceptualise it, value does not move from one asset to another. The metaphor is a false one.

Let us suppose that Jaamae holds title to a painting and in breach of trust he exchanges it for title to a sculpture that I hold. Now, in a sense, we can say we can identify the value in a new form and a title to the sculpture which Jaamae holds, but the truth is value has not moved from one asset to the other. Of course, Jaamae now has the value inherent in the title to the sculpture. But the reason that Jaamae has the value inherent in the title to the sculpture but the reason he has value inherent in the title of the sculpture is because I gave him the title to the sculpture, and the value inherent in the right to the painting are now with me. I now have the value inherent in the right to the painting. The point I am trying to make here is that while the value of any right can of course increase or decrease, it may be that the sculpture or painting gets damaged to decrease the value of the right. But the value itself does not detach from the right in question and start metaphorically moving to new assets. The metaphor just doesn't work.

Another approach, which I am not going to say a huge deal about, is that put forward by Justice Edelman and Elise Bant. That approach is that tracing is concerned with where one transaction, actual or anticipated, has caused another. In this sense, tracing is all about causally linked transactions. The problem with it is that it is inconsistent with every case which has ever considered the issue, including the House of Lords decision in *Foskett*, and perhaps more importantly for a Queensland audience, the Court of Appeal decision in [*Hanson v*] *Goomboorian* [*Transport Pty Ltd*] and all these authorities suggest that tracing is about attribution, it is not about establishing a but all causal link.

JH: We probably have to concede that the tracing value approach which Lionel Smith put forward and which the House of Lords adopted in *Foskett v McKeown* is the positive law in this country, at least below the High Court. But Jordan and I, in light of the problems with that approach, have come up with a different explanation for what tracing is, which we think is conceptually sound and consistent with the cases. Most importantly, we think that our approach allows us to address some of the difficult questions which arise in the law of tracing.

In brief, our answer is that tracing is concerned with the unauthorised use of rights, which we call the ‘original rights’ for convenience, to create or acquire new rights, which we refer to as the ‘substitute rights’, in circumstances which, generally speaking, must amount to a substitution. We have represented this on the slide [18].

At the start of the story, on the left-hand side of the slide, you have a trustee who has legal title to a piano, which is what we call the original rights. There is then a substitution where the trustee sells the piano or exchanges the piano for a bag of money. Then at the end of the story, on the right-hand side of the slide, you have the trustee with legal title to the bag of money, that is what we call ‘substitute rights’.

The next question, that is if that is what tracing is about, what is the effect of being able to trace from the original rights to the substitute rights? Now, Jordan is going to explain in a moment that generally speaking what you need to kick off the tracing process is equitable proprietary rights against the original rights. For convenience, we are going to call these the ‘old equitable proprietary rights’. We say the effect of tracing is that, if you are able to trace, tracing confers upon the claimant new equitable proprietary rights which mirror so far as possible the equitable primary rights, the claim that had against the original rights, and those new rights are against the substitute rights. It is important to notice that these are actually new rights. I say it is important because there are statements in cases such as *Foskett*, and many of the decisions which have applied it, that tracing is actually about enforcing the beneficiary's pre-existing equitable proprietary rights.

But that simply cannot be right. A right against legal title to a piano is simply not the same as a right against legal title to a bag of money. The rights against the legal title to the bag of money are new and they are created by the law of tracing.

To draw a number of strands together, and represent this entire process on one slide, on the left-hand side [of slide 20], at the start of the story, you can see that we have the same trustee who holds legal title to the piano, those are the original rights. The trustee holds that legal title to the piano on trust. And remembering that the equitable property rights under a trust are rights against rights, the beneficiary has equitable proprietary rights against those original rights, these are the old equitable property rights. There is then the exchange of the piano for a bag of money. On the right-hand side of this slide, you can see the trustee now has legal title to the bag of money, which are substitute rights and the beneficiary now has new equitable proprietary rights against the substitute rights against the legal title to the bag of money. It is those new equitable property rights which are conferred by tracing. That, in a nutshell, is how we explain the doctrine of tracing.

RULES OF TRACING

JH: Having looked at that, we can now look at more detail in the rules of tracing. We need to start by noticing that the orthodox view is that there is a distinction between tracing at common law and tracing in equity. That is put forward in cases like *Re Diplock* and *Foskett v McKeown*, which are noted on the slide [21]. The trouble with this view is that unfortunately it rests on a misreading on the 1815 decision in *Taylor v Plumer* which is said to be the very genesis of common law tracing. If you look at it, it is actually a case about tracing and equity, and the mistake was made because it was decided by a common law court.

The English courts, most famously in the case called *Jones v Jones* on the slide [21], have recognised this mistake, but have effectively said that look, yes, we got it wrong but too much water has passed under the bridge for us now to say that we made a mistake and common law tracing should never have been recognised. In fact, it has now been recognised by the House of Lords.

Jordan and I looked at the Australian position in some detail in the article that we have cited on the slide [21] and we looked at the position as a matter of authority, as a matter of principle, and as a matter of history. To sum up the article, the conclusion we reached was that although the question is still open, in most courts around Australia, we argue that common law tracing is not and should not be recognised in Australian law. Therefore, that is all we propose to say about common law tracing.

JE: With common law tracing now hopefully firmly in the waste bin, we can turn to consider the equitable tracing rules. The first question we need to consider is, as Jaamae foreshadowed a little bit earlier, is what do you need to show before you are able to trace an equity? The general requirement is said to be that you need to show the existence of an equitable proprietary right against the original right in question. This is sometimes referred to, and indeed was referred to by the Federal Court decision in *Grimaldi* [*v Chameleon Mining (No 2)*], as the need to establish proprietary base. You can see that if you want to trade some asset A into the asset B, you must first establish your proprietary rights in relation to asset A, keeping in mind that we will insert the words the rights that are held on trust in relation to asset A. What this means, and the key takeaway, is the legal owner without more cannot trace an equity. This all sounds very bleak to the legal owner who you might say is, you know, as seen as having somehow more rights than the so-called equitable owner. And it is not as bleak as it may seem to the legal owner for the following reasons.

The first is that the legal owner may be able to trace an equity if the events have independently given rise to an equitable proprietary right in his or her favour. A great example of this is the principle that a thief holds the possessory title, the title they acquire by virtue of their possession on the trust, and so if they use that possessory right to acquire a substitute right, they will have to substitute right on trust with the new owner.

The second one is that the legal owner may also be able to trace an equity if he or she has given control of the property to a person in circumstances which have imposed fiduciary obligations with respect to the property. A common example of this are directors of a company; a good example of this is also fiduciary bailments. In the very famous case of *Re Hallett's Estate*, which Jaamae is going to discuss in a couple of slides, the relevant solicitor actually held the bonds under a fiduciary bailment, he did not have the right or the title to the bonds.

IS THERE REQUIREMNT TO ESTABLISH FIDUCIARY RELATIONSHIP IN ALL CASES SEEKING TO TRACE AND EQUITY?

JE: However, a question which has arisen is, is there a further requirement that you need to establish a fiduciary relationship in all cases where you seek to trace an equity? This debate has arisen because of a number of statements which have been made in the English cases which are reproduced on this slide [23]. In the book, perhaps unsurprisingly by now, we argued that a number of these cases have been misinterpreted even in England.

Putting that point to one side, even leaving aside the fact that it is arguably resting upon a misinterpretation itself, the position has been criticised by many academics and including by judges who have considered the issue and the most notable one on the slide [23] being Lord Millett in *Foskett v McKeown*. However, in the United Kingdom it is treated as requirement as a matter of authority due to the decision in *Re Diplock*, which is the second case on the slide [23]. Fortunately, in Australian law we do not have the problems that the British do. The weight of authority is that it is simply not a requirement in Australian law. One major reason for that is that it is well established that tracing is possible where a constructive trust has arisen e.g. in the example of a thief holding a possessory title on constructive trust. And because the fiduciary obligation relationship is not a prerequisite to establishing a constructive trust, the cases on the slide [23] make the point that it therefore cannot be a prerequisite to tracing.

To sum up the conclusion for Australian law entitlements, going to the next slide [24]. The conclusion is the main authority is against the requirement of a fiduciary relationship in all cases. However, you do need to establish either an equitable proprietary right in the first instance, or a fiduciary duty in relation to the property. That point is then also made in the *Re French Caledonian Travel* decision saying that tracing can occur in relation to the asset where there is not a fiduciary relationship, provided that you can show an equitable right to the property proprietary right.

MIXING

JH: Having looked at are the prerequisites, we can now look in more detail at the tracing rules themselves. One scenario in which a number of problems arise is where there is mixing. Can I start by saying that mixing really falls into two categories. You have those types of cases where a wrongdoing trustee mixes trust money with his own money, a wrongdoer mixing money with that OF an innocent contributor. And you have those sorts of cases where a trustee mixes money from several different trusts, where money from several different innocent contributors is mixed.

I am going to start by talking about cases where the wrongdoer mixes their own money with trust money. We will come back to the other type later.

One reason why things become more complicated in a case like this is that where you then use money from the mixed fund to purchase the substitute rights, the mixing produces uncertainty. And so look at the example on the slide [25].

We have a trustee who misappropriates $100 trust money and combines it with $100 of his own money in a mixed fund. He then uses $100 of the $200 mixed fund to purchase a bicycle. The uncertainty is as to what money the trustee used to purchase the bicycle, and I should say I am referring to cash here.

There are really three possibilities here:

1) The trustee used only his own money, he used the $100 in cash that he put into the mix fund;
2) The trustee used $100 of trust money; or,
3) The trustee used some combination of trust money, and his own money.

Because cash is fungible, there is no way to tell as an evidential uncertainty as to what money the trustee used.

Now, it is important to note that when we are talking about things like cash it is an evidentiary uncertainty. But think about the more common case of a bank account. In that sort of case there is no uncertainty as such. There is no cash. We know exactly what the trustee did. He used his personal right against the bank, or part of that right, to acquire the title to the bicycle. But there is a similar problem, an analogous problem, of how we attribute the payments out i.e. the $100 out to buy the bicycle, to the two payments that were made in, the $100 of trust money and the $100 of his own money. And so, we have a similar problem arising regardless of whether cash or a bank account is used.

RULE IN RE HALLETT'S ESTATE & RULE IN RE OATWAY

JH: To address this sort of uncertainty, the law has developed two rules, the rule in *Re Hallett's Estate*, and the rule in *Re Oatway*.

Looking first at the rule in *Re Hallett's Estate*, the rule is said to treat the wrongdoer as having withdrawn his or her own money first. The result is that this allows the beneficiary to say that what remains in the account is trust money and to trace into that money.

We have an example on the slide [26], where a trustee knowingly mixes $10,000 of his own money with $10,000 of trust money, and then dissipates $10,000 from the mixture. We do not know whose money was actually used. Applying the rule in *Re Hallett's Estate* we can say that the wrongdoing trustee used his own money to dissipate, meaning the $10,000 which remains is deemed to be trust money, and the beneficiary can trace into it.

The second, the rule in *Re Oatway*, treats the wrongdoer as having purchased the substitute right using trust money and then as having dissipated his or her own money.

On the example on the slide [27], again, the trustee mixes $10,000 of his own money with $10,000 of trust money, but he then uses the first $10,000 to purchase a profitable investment and dissipates the remaining $10,000.

If we were to apply the rule in *Re Hallett's Estate* we would say the trustee used his own money to purchase the profitable investment and then dissipated the remaining $10,000 of trust money. You can see the unjustness in that result.

But the rule in *Re Oatway* says that the beneficiary can elect to take the profitable investment which was purchased first so that when the trustee dissipated the $10,000, he was dissipating his own money. The justification for this rule is clear, it is that the beneficiary should not be prejudiced and the wrongdoing trustee should not be advantaged by the rule in *Re Hallett's Estate* simply because what the trustee happened to do first turned out to be the more profitable course of action.

Having looked at those two rules, the next question is whether the beneficiary can, quote unquote, "cherry pick" between them. If we look at the problem on the slide [28] that illustrates this question.

We have the trustee mixing $10,000 of dollars of his own money with $10,000 of trust money, the same as the previous slides. But in this example, he purchases a profitable investment using the first $10,000 and then leaves the $10,000 still in the account.

If we apply the rule in *Re Hallett's Estate*, the $10,000 which remains in the account is trust money.

But if we apply the rule in *Re Oatway*, the profitable investment, which is probably worth more than $10,000 now, was purchased with trust money.

And so, the question is whether the beneficiary can choose between the two rules. Unsurprisingly, the answer which has been given in the cases is a resounding 'yes'. The plaintiff can choose whichever rule is the most advantageous to them. Justice Rymer in the English decision of *Shalson v Russo*, quite colourful put it this way, "If the beneficiary is not entitled to cherry pick, the wrongdoing trustee may be left with all cherries and the victim with nothing."

Now, I want to step back for a moment. So far we have been looking at these rules as deeming rules. We either apply the rule in *Re Hallett's Estate* or we apply the rule in *Re Oatway*, and the claimant can choose between them.

But what happens if there is a scenario where neither fund is sufficient on its own to replenish the trust fund? An example might be if the profitable investment fell in value below $10,000 and for various reasons only the $8,000 are remaining in the account - what can the claimant do then?

In our book, we argue that the true position is that we are not actually engaged in the application of rules and exceptions to rules. Rather, each of these rules is actually a manifestation of a single principle, which we call the 'subordination principle'. The subordination principle means this: until the trust fund is replenished the trustee is prevented from asserting anything but a qualified right to the fund and to anything acquired from the fund.

This idea is represented in the quote from Justice Einstein in the *Uniting Church* [*in Australian Property Trust (NSW) v Vincent*] case on the slide. The beneficiary is entitled to charge both the fund and any property acquired from the fund. Really, strictly speaking, the language of cherry picking is probably inaccurate. The beneficiary is not required to choose between the cherries, rather, he or she gets to keep all of the cherries until the trust fund is restored.

LOWEST INTERMEDIATE BALANCE RULE

JH: You will recall a couple of slides ago that I emphasised that the rules are the law's responses to uncertainty which arises when there is mixing. Because of this, the rules do not apply when there is no uncertainty. We can illustrate this by looking at a different rule of equitable tracing which is called the 'lowest intermediate balance rule'. I am going to go through the technical definition of the rule on this slide [29] and then we have worked it through as an example on the next slide [30], which will hopefully explain how the rule works.

Looking at the tracing exercise broadly, when you trace through a mixed fund or an account, at the start of the story you have a contribution of trust money to a fund. At the end of the story you have a fund with a balance. The tracing rules tell us how much of the money at the end of the story is to be treated as the trust money which was contributed at the start of the story. What the lowest intermediate balance rule says is that the sum of trust money that we find at the end of the story cannot be greater than the lowest balance which the fund achieved in the intermediate period. That rule is the combined effect of two propositions. The first proposition is that where money is taken out of an account, self evidently, it cannot be said that there is a greater amount in it than the balance of that time. Once the money has been taken out, the account balance is lowered. The second proposition is that even if the trustee later puts more money back into the account there is no presumption and no deeming rule that says that he intends to replace the trust money or that it will be treated as doing so. And so, the combined effect of these two rules is that once trust money has left the account it does not get replenished. There is an exception to that at the very bottom of this slide [29], but we do not need to concern ourselves with that for the moment.

Let me work through an example which will hopefully explain the effect of the rule. In this example [on slide 30], we have a trustee who takes $50 of trust money and mixes it with $50 of his own money. Out of that fund of $100 he then dissipates $80, leaving $20 in the account. Later, he puts $80 back into the account, $80 of his own money.

One approach, which we think is unprincipled, which we can call the 'simple *pari passu*' approach, is to just look at the fund at the end of the day. The account has $100 in it. We know that at the start of the story $50 of trust money was put into the account. We say that at the end of the day $50 of trust money must still be in the account, and so the beneficiary can assert equitable proprietary rights in relation to $50. But notice that this approach effectively ignores everything that happens between the start of the story when there is a contribution of trust money, and the end of the story when we look at the account balance.

Let's have a look at what happens if we don't ignore what happens in the interim. We have turned our example into a diagram here [on slide 31]. I should say immediately this is not a Christmas themed example. The green is the trustee's own money, good. The red is trust money, which the trustee should not be misappropriating, bad.

At stage A we can see the trustee has $50 of his own money in the account. At stage B, we see that he has added $50 of trust money. Then at stage C he has dissipated $80. The rule in *Re Hallett's Estate* tells us that he dissipated his own money first. But in this example, after he disappeared his own $50, he still dissipated another $30. And so logically, he must have dissipated $30 of trust money which means that we are left at stage C with $20 of trust money in the account. Finally, at stage D, the trustee puts $80 of his own money back into the account. And because we know that he is not presumed or deemed to have made good his previous breaches of trust the $80 remains his own money - and so it is green.

Having worked through the example like this, you can see that there can actually only be $20 of trust money left in the final balance of $100. So the beneficiary can only assert equitable proprietary rights in relation to $20. Contrast this with the approach which we reached on the previous slide, which was that the beneficiary could assert equitable proprietary rights in relation to $50. In essence, that is all the loss intermediate balance rule tells us. In the intermediate period between the start of the story when $50 was contributed and the end of the story when we find that account with $100 in it, the account's lowest balance was $20. And there can therefore be no more than $20 of trust money left in the account at the end regardless of how much other money is in the account.

MIXING INVOLVING INNOCENT CLAIMANTS

JE: The cases that Jaamae has just been referring to are all cases which involve mixing as between an innocent claimant and a wrongdoer. The wrongdoer, often named the trustee in breach of trust, has mixed trust money, his or her own money. What we want to consider in this section is, well what happens when the trustee doesn't mix the trust money with his or her own money but instead mixes it with other rights or other money which he is holding on trust for other equally innocent beneficiaries? These are so called innocent claimant cases or mixing involving innocent claimants.

You can see this sort of scenario in the example where that might arise. So, a trustee knowingly mixes $10,000 of trust money from trust A with $10,000 from trust B into the one bank account, and then he uses it to acquire some particular asset or some right.

The general rule in cases involving mixing as between innocent claimants is that losses and gains are to be born rateably or as in the technical nomenclature, *pari passu*. The key point being that because you can see the contributors are all innocent they must be treated equally amongst themselves, and neither innocent claimant's claim can be subordinated to the other.

That works really neatly whether you are talking about simply acquiring one particular asset or one right. But the reality is that in truth it is often much, much more complex. In the more common scenario what we are dealing with are bank accounts, and dealing with the issue of where there have been multiple payments in from innocent claimants but also then multiple payments out of the bank account. At the end, there is only a limited amount of fund which is not sufficient in order to satisfy every claimant's claim. The question then becomes, how does a lot to deal with this particular issue?

For some time, it was thought the rule in *Clayton's Case*, which is often called the ‘first in, first out’ rule, might be a way of dealing with this particular issue of solving this problem. According to this rule it is the first person who has contributed money to the fund or the first trust which has contributed money to the fund who is the first person on trust to lose money when a payment is made out - hence the rule first in, first out.

The rule and *Clayton's Case* has understandably been criticised for being completely irrational and arbitrary. The reason why it is arbitrary is because it depends upon the fortuity of the timing in which the trustee misappropriated the money from trust A rather than trust B. If trust A is misappropriated first and trust A is more likely to lose out. But if it happens that because of trusting the size of taking the trust B first, so it happens that it is more likely that trust B will lose out, even if there is only one subsequent withdrawal from the account. And so, it has been criticised for that reason, but perhaps more fundamentally, *Clayton's Case* was not a rule about tracing at all. The case itself had nothing to do with tracing.

What *Clayton's Case* was concerned with was the appropriation of payments as between a banker and its customer in relation to running accounts, and how they should be the payments out in relation to the amount owed by the bank. It just simply said nothing about tracing and has not been applied in cases involving wrongdoing, about what Jaamae was talking since *Re Hallett’s Estate*. One of the points was that it rejected the applications of *Clayton’s Case* there. So the idea that it might apply to innocent claimants mixing or mixing involving innocent claimants is a bit odd.

In England, it is still treated as a default rule. Fortunately, in Australia it has largely been rejected, for both reasons that we have given. In Australian law the rule of *Clayton’s Case* has been discarded.

THE ROLLING CHARGE/NORTH AMERICAN MODEL

JE: Another possible way of dealing with this problem is what is called the ‘rolling charge’ or the ‘North American’ model. This approach appears to have arisen in response to potential unfairness in applying what we might call the simple *pari passu* rule, the general rule, and simply saying, well, each contributor has contributed this much to the account and what we are going to say is at the end there is X amount remaining and we will divide it by reference to their initial contributions, ignoring whatever has happened in the interim.

The idea under the rolling charge method is that the innocent contributors would each receive a *pari passu* or rateable share, but one which is calculated after each and every transaction that has been made on the account. That means that it will always be subject to the lowest intermediate balance rule that Jaamae was speaking about earlier. The principal justification for this method is that it is more fair and coherent, and consistent with established rules of tracing. And so on the cases which I mentioned on the bottom half of the slide [34], those cases mentioned this is simply just a version of the lowest intermediate balance rule.

But then, to give an example, which we have taken from the English decision of *Shalson v Russo*, the citation is on the slide [35]. Imagine that you have a trustee who has $50 in the account, and thank you Jaamae for the helpful colouring once again, he misappropriates $25 from trust A and $25 in trust B, increasing the total balance of the account in the second box there to $100. Then let us suppose that he uses $50 from the account to acquire title to a car which is represented underneath the line.

Then in the second scenario, in the fourth stages scenario, he misappropriated $25 from trust C, bringing the account balance back up to $75.

Then let us suppose in the final stage of the scenario he dissipates $75 gambling, so there is nothing identifiable remaining.

If we were to apply the general rule, the rule that innocent claimants will be treated equally and have to share *pari passu*, and where to apply that rule without more, we would say that the only remaining asset or the only remaining rights for the fund is the title to the car. And because A, B and C each contributed equally to the fund in equal amounts, they can each assert a one third share relation to the title to the car. That is the case even though we know as a matter of fact the money misappropriated from the trustee could not have been used to acquire the title to the car. The reason we know that is because the title to the car was acquired in the third stage of scenario before the money from the trustee was misappropriated in the fourth stage.

If we were to apply the rolling charge approach we would say that at the point where title to the car was acquired, the only contribution to the fund had been from trust A and trust B in equal proportions. Therefore, trust A and trust B are the beneficiaries of that trust and can assert rights in respect of title to the car equally, but the beneficiaries of trust C cannot because their rights have been dissipated by the subsequent withdrawal of $75.

This is a particularly common problem. I should mention that those first two points on this next slide [36] represent that conclusion - so when you look at the slides later. This is a particular problem which happens where a trustee becomes insolvent. One difficulty is as an example we have given it is relatively simple to work out what the right principal position should be. But the problem is in insolvency you might have hundreds or thousands of transactions which have been made in a particular bank account. Iit is often much, much simpler to work out how much everyone has contributed, how much is remaining, and divide that amount, applying what we have called the simple *pari passu* approach.

Equally, it is often much, much more complex to apply the rolling charge method to each and every single transaction on the account to work out at each stage what was each person's proportionate share.

Hopefully as a matter of principle you can see that there is a tension here. The tension is that if one accepts the lowest intermediate balance rule, which all the Australian authorities do, there is no suggestion this is not a rule which applies in Australian law, then it is simply on principle to apply what we are calling the simple *pari passu* rule and to just divide the remaining amount at the end amongst all the claimants. The reason it is unprincipled is because it just ignores the factual realities of what has occurred in the account. Nonetheless, in the context of insolvency, we do have to recognise that the cost of achieving the principled result in full may sometimes be such that it results in less money being available overall distribution. This is probably the primary reason, the practical concern, why courts have often said that the rolling charge method is inappropriate in large and complex matters.

CARON V JAHANI (NO 2)

JH: To finish off, we thought we should discuss what we think, it is a recent decision, which we think is probably the most important decision on law tracing in the last five years, the decision of the New South Wales Court of Appeal in *Caron v Jahani (No 2)*.

Oversimplifying greatly the facts, there was a company which operated a Ponzi scheme, and eventually became insolvent. On a particular date, the 21 April 2017, the company's bank account was frozen. The total money in the account was not sufficient to meet the claims of the various investors, so there was a contest between two groups of investors, the respondents who were representing creditors who had deposited funds prior to the freezing order, and the appellants who represented creditors who had deposited funds after the freezing order for another five days up until the 26 April.

The issue was, how do we distribute these funds between the various investors in the company's insolvency? The primary judge, Justice Black, applied the simple *pari passu* approach, which is the approach we earlier referred to as unprincipled. He simply divided up the account proportionately according to the contributions of the investors.

The Court of Appeal allowed the appeal and permitted individual investors to prove their entitlement by applying the lowest intermediate bounce rule. To the extent that that was not possible it directed the liquidators to distribute *pari passu*.

The leading judgment was written by President Bell with whom Chief Justice Bathurst and Justice McFarlane agreed, it is a scholarly judgment, it is well worth reading. His Honour starts by noting that the ruling *Clayton's Case* has been rejected and the contest is really between two alternatives, the simple *pari passu* approach and the lowest intermediate balance rule. In the judgment President Bell equates the lowest intermediate balance rule with the North American, or the rolling charge, model. He noted that the objections to the lowest intermediate bounce rule/rolling charge model are not objections in principle, they are practical objections. As Jordan said earlier, in particularly difficult complex matters, it can be very costly to apply this method because it requires you to analyse the state of affairs at every transaction in the account. Ultimately, President Bell preferred that approach and he gave a number of reasons for this. Most importantly, he said that it "…recognises the continuing fatality of clearly discernible property rights". He also explained that it was, in his opinion, "…the fairest, most equitable and principled outcome for the allocation of limited funds between investors". He also pointed to a number of advantages of the lowest intermediate balance rule or the rolling charge approach. The main one was that it avoided a negative consequence of the simple *pari passu* approach. That negative consequence is that later investors whose funds have not really been dissipated would have subsidised earlier investors whose funds had by that point largely been used up. But that negative consequence is avoided when we use the rolling charge model because we analyse the party's entitlements at each transaction, so it takes account of whose money has been dissipated and when.

The eventual approach which the Court of Appeal adopted was that individual claimants were allowed to establish their equitable proprietary rights by reference to the tracing rules and by reference to the lowest intermediate balance rule, but to the extent that was not possible the court directed the liquidator to distribute the remaining funds *pari passu* among the creditors.

JE: A particularly noteworthy feature of *Caron* is that it involved a partial application of the rolling charge approach. Something which we may not actually have made clear yet was that there was only one withdrawal subsequent to the freezing order and the rolling challenge approach to the lowest intermediate balance was only applied to that last transaction on the account. This is what we have called the simplified rolling challenge approach. So that it should be applied to the extent that it is possible to do so.

For those who are interested, this approach actually has been considered before in England in a decision of Justice Henderson called [*Charity Commission for England and Wales v*] *Framjee* which unfortunately was not discussed in *Caron* but in *Framjee* on almost materially identical facts Justice Henderson said there is no room for a halfway house which applies a rolling charge method on a selective basis.

We argue the approach in *Caron* is to be preferred. The effect of that is to say that courts should where possible give effect to the lowest intermediate balance rule by applying the rolling charge approach, even if only in parts, applying in cases where it is clear that there has been a particular transaction, which means that for example one equitable investor's funds have not been dissipated by withdrawal. If that all sounds very interesting, a bit of selfpromotion, we refer you to our note which is due to come out in the Law of Review any day now.

That might be a convenient point at which to note we have these slides at the end which will be sent out, they are for reference only though. Of course, we welcome any questions on them by email. But it might be a convenient point to pause and see if there are any questions that you have now, which I understand can be asked via the chat function.

HOW SUBSTITUTE RIGHTS PLAY OUT WHEN THE SUBSTITUTE PROPERTY INCREASES IN VALUE

JE: I have one [question] that was sent to me privately. The question was, how do substitute rights play out when the substitute property is an asset which increases in value?

Suppose we have $100 cash which is converted into shares which increase over time. I think, if Jaamae permits me to take this one, I think in some ways that is the benefit of our approach, which is concerned with substitute rights. So, because we are not concerned with value moving from one asset to another, we don't face these conceptual problems of how can the title to a sculpture only worth $10,000 suddenly become titled to a painting which is worth, you know, $30,000? How can the value when it transfers suddenly increase by, you know, $20,000? Whereas we are saying that that is a simple point, we are saying you were required to hold this right on trust for me. What you did instead is acquired a substitute right. You must now hold that substitute right on trust and the value of that substitute right is irrelevant. It may in fact, be less. This has particular difficulties when you go to why isn't that we trace, and we haven't touched upon that sort of very academic debate is tracing about unjust enrichment, or these other things. Short answer, no it is not. But this creates more issues when dealing with it from an academic perspective, but on the mechanics of it it presents no issue, we are talking about the acquisition of a right.

JH: I think that is all the questions Bianca.

BK: Wonderful. All right. Well, on behalf of everyone, Jordan and Jaamae, can I thank you very much for an excellent and engaging presentation this evening. I am sure that everyone watching has learned a great deal from your helpful explanations.

I will just add a reminder to what Jordan just said everyone, the slides and the video of tonight will be distributed tomorrow.

To you all, can I reiterate my thanks to you all for joining us virtually this evening. We hope we can welcome you all again, both virtually and in person. In the meantime, wishing you all a safe and happy holiday period. Thank you very much.

JH: Thanks everyone. Thanks Bianca.