Principles of Tracing: Real Estate Litigation

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PRINCIPLES OF TRACING: REAL ESTATE LITIGATION

I. Introduction **1**

II. Related Remedies and the Role of Tracing **2**

A. Constructive Trusts 2

B. Express or Implied Trusts 3

C. Equitable Liens and Equitable Charges 4

D. Fraudulent Conveyances 5

III. Availability of Tracing as a Remedy **6**

IV. Competing Claims to a Fund or Property **9**

V. Extending Remedy to Assets not Directly Traceable **13**

VI. Adequacy of pleadings **15**

VII. Two-stage Trials **16**

VIII. Conclusions **18**

I. Introduction

Tracing (sometimes called "following") may be used to describe one or more of an equitable remedy, a remedy at law, or an accounting process.

The equitable remedy of tracing is almost always asserted in equity as an adjunct to one or more other equitable remedies which form the "proprietary base" for the entitlement to trace. At common, it may be asserted where possession has passed but legal title remains with the claimant.

As an accounting process, tracing is a mechanism used to establish whether and to what extent such an equitable remedy may be available. It may also be used to follow property which has been converted into other forms or transferred into the hands of others, even where a "proprietary base" is not established.

II. Related Remedies and the Role of Tracing

Tracing may be available as an equitable remedy where there is an equitable lien or charge on assets; an express, implied or constructive trust; or a statutory trust (e.g. pursuant to the *Builders Lien Act,* SBC 1997, c. 45).

Tracing as an accounting process may also give rise to an effective remedy in cases where a proprietary remedy does not exist and is not imposed by the court, for example where a creditor traces assets into the hands of others pursuant to the *Fraudulent Conveyance Act*, RSBC 1996, c. 163. The same or a similar regime may arise under the *Bankruptcy and Insolvency Act,* RSC 1985, c. B-3.

A. Constructive Trusts

A constructive trust may be ordered where "good conscience" requires. There are two basic categories of constructive trust: "*institutional*" (a.k.a. "*substantive*") constructive trusts and "*remedial*" constructive trusts.

The distinction between substantive and remedial constructive trusts was set out by Lambert J.A. in *Atlas Cabinets and Furniture Ltd. v. National Trust Co*. (1990) 45 B.C.L.R. (2d) 99 (C.A.):

> A substantive constructive trust must be distinguished from a remedial constructive trust. In a substantive constructive trust, the acts of the parties in relation to some property are such that those acts are later declared by a court to have given rise to a substantive constructive trust <u>and to have done so at the time when the acts of the parties brought the trust into being</u>. ... <u>In a remedial constructive trust, on the other hand</u>, the acts of the parties are such that a wrong is done by one of them to another so that, <u>while no substantive trust relationship is then and there brought into being by those acts, nonetheless a remedy is required in relation to property</u> and the court grants that remedy in the form of a declaration which, when the order is made, creates a constructive trust by one of the parties in favour of another party. [At 108; emphasis added.]

Two criteria must normally be satisfied for a constructive trust to be found: (1) a monetary award must be inadequate, and (2) there is identifiable property to which the plaintiff contributed in some manner. In the current leading authority, *Kerr v. Baranow*, 2011 SCC 1, at para. 50., Cromwell J. explained that in order to make out a constructive trust, the plaintiff must be able to point to a link or causal connection between his or her contribution and the acquisition of specific property:

> . . . the constructive trust is a broad and flexible equitable tool used to determine beneficial entitlement to property (*Pettkus*, at pp. 843-44 and 847-48). Where the plaintiff can demonstrate a link or causal connection between his or her contributions and the acquisition, preservation, maintenance or improvement of the disputed property, a share of the property proportionate to the unjust enrichment can be impressed with a constructive trust in his or her favour (*Pettkus*, at pp. 852-53; *Sorochan*, at p. 50).

Remedial constructive trusts are commonly available to remedy a wrong with its roots in unjust enrichment. In *Pettkus v. Becker* [1980] 2 S.C.R. 834, Dickson J. held at 847-8:

> The principle of unjust enrichment lies at the heart of the constructive trust. "Unjust enrichment" has played a role in Anglo-American legal writing for centuries. Lord Mansfield, in the case of *Moses v. Macferlan* put the matter in

> these words: "… the gist of this kind of action is, that the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money". It would be undesirable, and indeed impossible, to attempt to define all the circumstances in which an unjust enrichment might arise …. The great advantage of ancient principles of equity is their flexibility: the judiciary is thus able to shape these malleable principles so as to accommodate the change in needs and mores of society, in order to achieve justice. The constructive trust has proven to be a useful tool in the judicial armory …. [At 847-8.]

The remedy was initially used primarily as "a proprietary device that could resolve, at least in some cases, the injustice inherent in the common law of matrimonial property": *BNSF Railway Company v. Teck Metals Ltd.,* 2016 BCCA 350 at para. 26.

Constructive trust scenarios have also evolved to include cases of breaches of fiduciary duty and fraud. In *Soulos v. Korkontzilas* [1997] 2 S.C.R. 217, a realtor's taking, in his wife's name, of a client's opportunity to purchase property was said to give rise to a substantive constructive trust, i.e. one which had always existed. The requirements for imposition of the trust were (1) that the defendant was under an equitable obligation in relation to the activities giving rise to assets in his or her hands; (2) that those assets are shown to have resulted from activities in breach of the equitable obligation; (3) that there is a legitimate reason for seeking a proprietary remedy (such as ensuring such persons remain faithful to their duties); and (4) that there are no factors rendering such a trust unjust (such as innocent third parties).

McLachlan J.A. (as she then was), speaking for the majority at para. 17, referred to the constructive trust as being imposed "not only to remedy unjust enrichment, but to hold persons in different situations to high standards of trust and probity and prevent them from retaining property which 'in good conscience' they should not be permitted to retain."

Following a series of remedial constructive trust cases, in *BNSF Railway Company v. Teck Metals Ltd., supra*, Newbury J.A., for the court, confirmed that "the 'ancient and eclectic' institution of the substantive constructive trust has not been 'expunged' in Canada by the development of its remedial counterpart". In that case, the plaintiff's claim for moneys had and received, subsumed in the law of restitution, was held to ground an action for a substantive trust.

B. Express or Implied Trusts

Tracing can be established where property has been transferred in breach of an express or implied trust. Such a claim will follow the requirements set out above, namely, the plaintiff will have to identify the property into which the trust property has been converted and the remedy must not be precluded by *bona fide* third party rights. Subject to the foregoing, the claimant will be entitled to an *in rem* claim in the destination property as well as other property into which it may have been subsequently converted, whether directly or indirectly.

A traceable express trust was identified in *PricewaterhouseCoopers v Bank of Montreal*, 2017 NLTD(G) 43, a case involving a realty company in receivership. The court held at para. 12:

> The three certainties of trust are made out with regard to the Traceable Funds:
>
> 1) There was an intention to create a trust: the Traceable Funds were paid to 50549 on the basis that they would be held for the benefit of the vendor or purchaser;
>
> 2) The subject matter of the trust is certain: the amount of the deposit in respect of a given transaction;
>
> 3) The vendors and purchasers that are the beneficiaries of the trust are certain: trust interests in the Traceable Funds are limited to the vendors and purchasers on each transaction.
>
> 13 As a result, subject only to the contractual right of 50549 to withhold commissions from deposits credited to vendors, the Traceable Funds are subject to an express trust in favour of the vendors and purchasers, and must be disbursed to vendors and purchasers as required by each transaction.

C. Equitable Liens and Equitable Charges

The historical distinction between equitable liens and equitable charges has been much written about but inconsistently applied, with nomenclature varying over time and across jurisdictions. Sometimes, the two concepts are combined into the term "charging lien". I will not focus too heavily on the distinctions in terminology in the course of this discussion on tracing.

Equitable liens and charges arise largely in three situations: by course of conduct; by agreement; or by statute.

Equitable liens arising by course of conduct are sometimes called "true equitable liens" and arise by operation of law to redress situations of unjust enrichment where it is "just and equitable" to impose them. Per Snell's Principles of Equity, these liens confer "a charge upon property until certain claims are satisfied", "[exist] independently of possession", and are "enforceable by means of an order for sale."[2]

For example, by operation of law an unpaid vendor of property is given a lien over the property for which he or she has not yet been paid. Such liens were considered in the development of the constructive trust and their utility may overlap with that remedy.

Similarly, an equitable charge is created "when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realization by judicial process, that is to say, by the appointment of a receiver or an order for sale": *Swiss Bank Corp. v. Lloyds Bank Ltd.*, [1982] A.C. 584 (HL).

The interest in property arising from an equitable charge was reviewed by Barbara Cotton in her article, "The Equitable Lien: New Life In an Old Remedy?"[3], as follows:

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2 Snell's Principles of Equity, P.V. Baker and P. St. J. Langan, eds., 29th ed. (London: Sweet & Maxwell Ltd., 1990), p. 456

3 Barbara Cotton, "The Equitable Lien: New Life In an Old Remedy?", http://www.bottomlineresearch.ca/pdf/equitable_lien.pdf

> An equitable mortgage is an interest in property and is different from an equitable lien in that it grants the mortgage the additional right to foreclose against the property. All equitable mortgages are equitable liens, but not all equitable liens are equitable mortgages. The distinction between the two is articulated by Buckley L.J. in Swiss Bank:
>
> > An equitable charge may, it is said, take the form either of an equitable mortgage or of an equitable charge not by way of mortgage. An equitable mortgage is created when the legal owner of the property constituting the security enters into some instrument or does some act which, though insufficient to confer a legal estate or title in the subject matter upon the mortgagee, nevertheless demonstrates a binding intention to create a security in favour of the mortgagee . . . An equitable charge which is not an equitable mortgage is said to be created when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realization by judicial process, that is to say, by the appointment of a receiver or an order for sale."

In some cases, the facts may allow a plaintiff to elect between an equitable lien and a constructive trust. A trust will generally be chosen where property has increased in value whether through accumulated profits, capital gains or a combination of the two. If the property has decreased in value, the plaintiff would prefer an equitable lien, preserving the right to claim against other assets.

The equitable lien is to be distinguished from a legal possessory lien over the client's property which arises in certain situations. A solicitor's lien may be used to secure fees and disbursements where property has been recovered or preserved as a result of a litigation proceeding in which the solicitor has been involved. As discussed in *Wilson King & Co v Lyall (Trustees of)*, 1987 BCJ No. 709, 12 BCLR (2d) 353 (CA), the purpose of a "charging lien" is to protect a lawyer from the unjust result of recovering or protecting property and not receiving full payment for services rendered.

As noted by the Law Society of British Columbia in "Solicitor's Liens and Charging Orders" updated to July 2013, a charging lien may not fall under the traditional definition of a "lien", as it may include property which is not in the solicitor's possession. Rather, it reflects the solicitor's right to request the equitable interference of the court and claim a charge against property that has been recovered or preserved through his or her efforts. In British Columbia, this right at common law has been codified in section 79 of the *Legal Profession Act*, SBC 1998, c. 9, which provides that a "lawyer who is retained to prosecute or defend a proceeding in a court or before a tribunal has a charge against any property that is recovered or preserved as a result of the proceeding for the proper fees, charges and disbursements of or in relation to the proceeding, including counsel fees".

D. Fraudulent Conveyances

Tracing is regularly used to attach assets which have reached others through fraud. The claimant may have a proprietary claim to the source or "referable" property by virtue of an express, implied or constructive trust, or an equitable lien or charge, for which case tracing may be an ancillary remedy.

Where there is no proprietary claim, tracing as an accounting process may nevertheless be mandated by governing legislation such as the *Fraudulent Conveyance Act*, *supra*, which renders a disposition of property void and of no effect against a person whose rights and obligations are or might thereby be "disturbed, hindered, delayed or defrauded", unless the disposition was made "for good consideration and in good faith lawfully transferred to a person who, at the time of the transfer, has no notice or knowledge of collusion or fraud".

To similar effect, under the *Fraudulent Preference Act*, RSBC 1996, c. 164, a disposition of property by a person at a time when that person is in insolvent circumstances, is unable to pay his or her debts in full, or knows that he or she is on the eve of insolvency, is void as against an injured creditor if the disposition was made with the intent to defeat, hinder, delay or prejudice creditors or to give one or more creditors a preference over others. Dispositions made with the effect, but not the intent, of giving preference to any creditor may nevertheless be void if the proceeding to set it aside is brought within 60 days.

In regard to fraudulent conveyances and preferences and their counterparts under the *Bankruptcy and Insolvency Act, supra*, the distinction between tracing as an accounting process and tracing as an ancillary remedy is critical to the consequences for the parties and others. Where the tracing claim is ancillary to a proprietary claim, the claimant may (subject to the rights of third parties) be entitled to a declaration that the traced property belongs to the claimant and an order that it be transferred accordingly (or that it be sold and the net proceeds transferred to the claimant).

On the other hand, when used as an accounting process under these or other statutory provisions, the consequences are generally that the transfer is unwound, the transferee and transferor are restored to their original positions, and the transferred property is sold and the proceeds (normally net of costs borne by the claimant) are distributed amongst all creditors legally entitled. Claimants without a proprietary interest may be subordinated to those with a proprietary interest.

III. Availability of Tracing as a Remedy

The availability of tracing as a remedy presupposes that specific funds or property can be located and readily identified, whether in a segregated fund, in a mixed fund, or in other property acquired therewith. Equally fundamental is the requirement that the property has not been transferred to a *bona fide* purchaser for value without notice. These principles were enunciated as follows in *McTaggart v. Boffo* (1975) 64 D.L.R. (3d) 441 (Ont. H.C.J.) at 458:

> Tracing is only possible so long as the funds can be followed in a true sense, i.e., so long as, whether mixed or unmixed, it can be located and identified. It presupposes the continued existence of the money either as a separate fund or as part of a mixed fund or as latent in property acquired by the means of such a fund. Simply put, two things will absolutely prevent the tracing of trust monies:
>
> > a. If, on the fact of any individual case, such continued existence of the identifiable trust fund is not established, equity is helpless to trace it;
> >
> > b. the chain for tracing is also broken where the trust fund either in its initial form or a converted form has found its way into the hands of a third person purchaser for value without notice.

The leading British Columbia authority on tracing is the Court of Appeal's 2010 decision in (the aptly-named) *Tracy v. Instaloans Financial Solutions Centres (B.C.) Ltd.* 2010 BCCA 357, in which the court cited with approval the foregoing principles from *McTaggart*. In *Tracy*, the court traced funds impressed with a constructive trust, by virtue of their having been unlawfully collected by payday loan companies from their customers, into the hands of certain affiliated corporations. Newbury JA, for the court, considered the nature of the process of tracing:

> [41] I conclude, then, that the trial judge considered the correct legal "tests" in approving a constructive trust as a restitutionary remedy for the defendants' unjust enrichment. As mentioned above, however, it is only if the Unlawful Finance Charges or their proceeds are identifiable in the hands of defendants farther up the transactional chain than the Storefront Lenders that a constructive trust may be asserted against those defendants. <u>The process by which the plaintiffs may 'follow' the Charges up the chain is tracing – the "process by which the plaintiff traces what has happened to his property, identifies the persons who have handled or received it, and justifies his claim that the money which they handled or received ... can properly be regarded as representing his property</u>**"**. (Per Millett L.J. (as he then was) in Boscawen v. Bajwa [1995] 4 All E.R. 769 (C.A.) at 776.) <u>Although tracing is available both at law and in Equity (see Maddaugh and McCamus, supra, at chapters 6 and 7), the right which the plaintiffs are entitled to trace in this case is the constructive trust, an equitable property right. I agree with Professor Lionel Smith (The Law of Tracing (1997)) that the establishment of this proprietary right, which he refers to as the "proprietary base", is sufficient to establish an entitlement to trace.</u> It is not necessary, as was once argued, to demonstrate a pre-existing fiduciary relationship: see Citadel General Assurance Co. v. Lloyds Bank Canada [1997] 3 S.C.R. 805 at para. 57. (emphasis added)

Tracy will be addressed in further detail, *infra*.

In *Jacobs v Yehia,* 2015 BCSC 267, the Court found at an interlocutory stage that there was an arguable case for the imposition of a remedial constructive trust in certain property into which misappropriated funds might be traced. Such property could be impressed with a trust either directly through unjust enrichment or indirectly by tracing property acquired with ill-gotten funds. As a result, the certificate of pending litigation was sustainable.

In *Edmonton Region Community Board for Persons with Development Disabilities v Pearl Villa Homes Ltd.,* 2010 ABQB 786, the plaintiff alleged that from 2000 to 2003, the defendant had over-billed and was remunerated by the plaintiff for over $3 million in services it did not actually provide. There was evidence that the funds so obtained were transferred to certain persons who used them to pay down mortgages. The Court found that it was therefore not plain and obvious that the Plaintiff could not succeed in its claim for a constructive trust over the ultimate properties. The court noted that such a trust would be subject to the limitations of the tracing process, which limitations are discussed below.

The courts of British Columbia have also recognized the applicability of the tracing remedy in conjunction with the *Fraudulent Conveyance Act* and *Fraudulent Preference Act*. For instance, in *Barregar v. Turi,* 1997 CanLII 934 (BCSC), the court traced the proceeds of a fraudulent conveyance into a property subsequently purchased by the defendant's son and parents. The court concluded, at para. 40, that "when property in the hands of a fraudulent purchaser is converted into money, the fund, once created, is impressed with the same trust as the property in its original form" and declared that the defendant's family members held in trust for the defendant an undivided one-half interest in the subsequent property.

Further, the claimant pursuing the tracing remedy need not have been a creditor at the time that the conveyance took place. In *Guthrie v. Abakhan & Associates Inc.,* 2017 BCCA 102, the appellant's ex-husband had fraudulently conveyed his property to his second wife. The appellant later sought support arrears against the ex-husband and obtained a declaration from the court that the conveyance was fraudulent and an order awarding costs, which she then registered against the property. The property thereafter went into foreclosure and the proceeds of the sale were paid to a trustee in bankruptcy, who disputed the appellant's claim.

In finding that that the trial judge had erred by holding that the declaration under the *Fraudulent Conveyance Act* applied only for the purposes of the appellant's claim for support arrears, Newbury J.A. concluded as follows:

> [26] I agree with the appellant's submission, then, that the chambers judge erred in holding that the orders made by Humphries J. validly restricted Ms. Guthrie's remedies under the *Fraudulent Conveyance Act* to the enforcement of Mr. Michie's child support arrears. No authority was cited to us, and I have found none, that suggests it is open to a court to declare a fraudulent transfer "void" under the Act *only to a certain extent* or *only to permit a certain debt* to be recovered; to declare a transfer void *only as against a particular creditor* but not as against other creditors delayed or hindered by the transfer; or to declare a transfer void *only for a limited time*. **Once a conveyance has been found to infringe the Act, it remains fraudulent, and is ineffective as against all creditors who may be hindered or delayed.** As counsel for the appellant suggested, it would be "contrary to logic" as well as to authority (and in this case would be placing form over substance) to require that a creditor who wishes to enforce more than one judgment return to court to have the same transaction declared void "time and time again". Similarly, it would offend the purpose of the Act to require that creditor after creditor prove in court that the same transfer was intended to avoid the just claims of creditors.
>
> [27] On this point, I note in particular *Canadian Imperial Bank of Commerce v. Boukalis* (1987) 1987 CanLII 2694 (BC CA), 11 B.C.L.R. (2d) 190*, lve. ref'd*. [1987] S.C.C.A. No. 180, in which this court (sitting with five justices) ruled that a person who was a *secured* creditor at the time of a fraudulent conveyance had standing to sue under the *Fraudulent Conveyance Act*, as could a person who became a creditor *after* the conveyance took place. The Court cited with approval the following passage from *Reid v. Kennedy* (1874) 21 Gr. 86:
>
> > The words in the Act are "creditors and others," and proving that the conveyance was tainted with fraud once, I do not think it loses this stain, but remains a conveyance with this infirmity which prevents it being set up as against a creditor whose debt arises years after the instrument was executed. The words "and others" extend the operation of the Act if the word creditors confined it to those existing when the deed was made. [Quoted at 195 of *Boukalis*; emphasis added.]
>
> and *Petrone v. Jones* (1995) 1995 CanLII 7374 (ON SC), 33 C.B.R. (3d) 17 (Ont. Gen. Div.), where the Court rejected the suggestion that "a transaction entered into with the specific intent of defeating, hindering, delaying…one creditor may be valid as against another creditor." (At 19).

IV. Competing Claims to a Fund or Property

As early as 1880, Jessel MR, in *Re Hallett's Estate* (1880) 13 Ch. D. 696, observed (at 710) that "modern [tracing] rules ... have been ... altered, improved, and refined from time to time". In *Canson Enterprises Ltd. v. Boughton & Co.*, [1991] 3 S.C.R. 534, McLachlin J.A. (as she then was) noted that equity's "flexible remedies such as constructive trusts, account, tracing and compensation must continue to be moulded to meet the requirements of fairness and justice in specific situations".

An excellent summary of the courts' evolving approaches to competing claims to a common fund was set out by Yamauchi J. in *Easy Loan Corp v Base Mortgage & Investments Ltd*, 2016 ABQB 77, which is set out verbatim below.

While the facts in *Easy Loan* involved competing claims to a bank account, its principles may be equally applicable in respect of competing claims to one or more properties funded by multiple contributors, either directly or indirectly, from an original fund or funds.

Yamauchi J. considered that, by ordering the distribution of funds to competing claimants, the court was essentially undertaking "loss allocation among the various investors" (at para 54). He then continued:

> 55 Canadian courts have determined that there are 3 ways in which this Court could order the distribution of the monies in the Bank Account among the Applicants and other investors, which are as follows:
>
> > (1) "First in, first out": this is derived from the *Clayton's Case, Re* (1816), 1 Mer. 572 (Eng. Ch. Div.) [*Clayton's Case*], where the court held that the first money deposited into the account is presumed to be the first money withdrawn;
> >
> > (2) *Pro rata* or *pro rata ex post facto* sharing based on the original contribution that the various claimants made, regardless of the time they made their contributions. If there is a shortfall, between the amount the claimant's claim and the amount remaining in the account, the claimants share proportionately, based on the amount of their original contribution;
> >
> > (3) Pro rata sharing based on tracing or the lowest intermediate balance rule ("LIBR") which says that a claimant cannot claim an amount in excess of the lowest balance in a fund subsequent to their investment but before the next claimant makes its investment.
>
> 56 Although the rule in *Clayton's Case* has been used by Canadian courts, practically it has fallen is [sic] disuse because it is "arbitrary and unfair*": Ontario (Securities Commission) v. Greymac Credit Corp*. (1986), 55 O.R. (2d) 673, 30 D.L.R. (4th) 1 (Ont. C.A.) [*Greymac*, cited to DLR], aff'd [1988] 2 S.C.R. 172 (S.C.C.).
>
> 57 In *Greymac*, the Ontario Court of Appeal provided the following quotation *from Walter J. Schmidt & Co., Re*, 298 Fed. 314 (U.S. Dist. Ct. S.D. N.Y. 1923), at 316 in support of its holding:
>
> > The rule in Clayton's Case is to allocate the payments upon an account. Some rule had to be adopted, and though any presumption of intent was a fiction, priority in time was the most natural basis of allocation. It has no relevancy whatever to a case like this. Here two people are jointly interested in a fund held for them by a common trustee. There is no reason in law or justice why his depredations upon the fund should not be borne equally between them. 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, supra. When the law adopts a fiction, it is, or at least it should be, for some purpose of justice.
>
> *Greymac* at 15.

58 Of course, the reason why the rule in *Clayton's Case* is considered arbitrary and unfair is because it is prejudicial to those who contributed earliest to the fund. The reason it is a fiction is that no one knows with any certainty that the withdrawals from the fund were taken from the money first deposited. There is no allocation of loss. It places the loss squarely at the feet of those who deposited their funds earliest.

59 None of the parties in the case at bar has asked this Court to apply the rule in *Clayton's Case* to the loss allocation it is considering. This Court agrees and will not discuss that case any further.

60 The LIBR approach assumes that the investor can identify the monies it has deposited into the fund. The sum of the amount existing in the fund at the time of the investor's deposit and the investor's deposit make up the total of the fund at that time. A simple calculation will determine the percentage of each to the total amount that makes up the fund. Sulatycky ACJ in *Elliott, Re*, 2002 ABQB 1122, 11 Alta. L.R. (4th) 358, 333 A.R. 39 (Alta. Q.B.) [*Elliott*] then outlines the way in which LIBR will work as follows:

> ... [W]here the funds in an account are depleted below the trust money balance, further deposits by the trustee cannot be accessed by the beneficiaries. They are, instead, limited to the lowest intermediate balance of the account. This is rational, because the entire line of cases being discussed is based on equitable rules of tracing. It is impossible to affix money subsequently deposited with the imprint of tracing. Only the money still remaining can be traced.

61 In *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)*, 2012 ONSC 3185, 111 O.R. (3d) 700, 95 C.B.R. (5th) 239(Ont. S.C.J. [Commercial List]), aff'd 2013 ONCA 26, 5 C.B.R. (6th) 113 (Ont. C.A.) [*Boughner*, cited to ONSC], Morawetz J provides the following example of how LIBR works:

> ... A invests $100 in a fund. The value of the fund then declines to $50. B invests $100, bringing the balance in the fund to $150. The value of the fund then declines to $120.
>
> In this fact pattern, if LIBR were applied, A could not claim more than $50, because that is the lowest balance in the fund prior to B's investment. In other words, the initial decline in the value of the fund from $100 to $50 is borne entirely by A. When B contributes $100, her investment constitutes 2/3 of the $150 in the fund. As a result, when the fund declines to $120, 2/3 of the decline is borne by B, while 1/3 is borne by A. Therefore, of the $120 remaining in the fund, A can claim $40 while B can claim $80.
>
> *Boughner* at paras 4-5.

62 In the end, the LIBR approach does not permit an investor to receive more than what can be traced from their contribution. Timing is important.

63 Timing is not so important in the pro rata ex post facto approach, which Sulatycky ACJ described in *Elliott* as follows:

> In the *pari passu ex post facto approach* applied in *Law Society of Upper Canada v. Toronto Dominion Bank*, the total quantum of available assets is determined — i.e., the amount remaining in the trust accounts. The funds are then shared proportionally among the contributors to the fund (except for any

money contributed by the trustee, as that is considered applied to the shortfall). The date of deposits is ignored.

64 Thus, in the example that Morawetz J provides in *Boughner*, A and B would receive $60, as each invested an equal amount of $100.

65 Thus, there are 2 approaches that this Court can consider when determining how best to distribute the monies in the Bank Account. Both have their advantages and disadvantages, which this Court will discuss in a moment. The overarching aspect, however, is that this Court must apply an approach that is logical, just, equitable and convenient: *Greymac* at 7; *Law Society of Upper Canada v. Toronto Dominion Bank* (1998), 169 D.L.R. (4th) 353, 42 O.R. (3d) 257, 44 B.L.R. (2d) 72 (Ont. C.A.) [*TD Bank*, cited to DLR] at para 31.

66 The LIBR approach has been criticized as being the reverse of the rule in *Clayton's Case* in the sense that it is a "last in, first out" approach: *TD Bank* at para 9. As well, the LIBR approach is more difficult and more complicated than the *pari passu ex post facto* approach and, accordingly, the court should try to find a solution that is workable: *TD Bank* at paras 33-34; *Greymac* at 17. Furthermore, the LIBR approach is difficult to apply "where there are numerous deposits and withdrawals, as the LIBR has to be determined at multiple points throughout the account's history: *Elliott* at para 37.

67 The *pari passu ex post facto* approach, on the other hand, "seems unfair to late investors": *Boughner* at para 42, quoting *Barlow Clowes International Ltd. v. Vaughan* (1991), [1992] 4 All E.R. 22 (Eng. C.A.). As stated in *Waters* at 1283, "Although there is a certain fairness in proportionate sharing, this approach shifts earlier losses onto later contributions, whose money could not possibly have been implicated in those losses." Furthermore, in the case at bar, certain of the Applicants have acknowledged that they received payments of some form or another from Base Finance. As Morawetz J said in *Boughner*, "Just as earlier investors would not have expected to share their gains with later investors, they should not be allowed to so share their losses": *Boughner* at para 56.

68 The *pari passu ex post facto* is more simple to apply. One simply takes the total amount remaining in the Bank Account and divides it proportionately among the investors in accordance with the deposits they made into the Bank Account. There is a certain complexity, however, in this approach. The Bank Account had an opening balance. How does one distribute the opening balance among the investors? Did those earlier investors, or some of them, invest in a legitimate scheme, or were they similarly "duped" by Mr. Breitkreuz? Which ones were duped? Must the amounts that Applicants and others received from the Bank Account be accounted for in calculating their losses?

69 In the case at bar, the parties have advised this Court that they have access to the complete records of the Bank Account from the date that Base Finance opened the account sometime in May of 2014, which shows not only the debits and credits, but also the balances in the account for all those transactions. As well, this Court assumes that RBC can provide the parties with the cancelled cheques that show the deposits. This differs from *Elliott*, where the parties provided Sulatycky ACJ merely with "evidence as to final balances and the dates and amounts of the claimants' deposits": *Elliott* at para 31. How could Sulatycky ACJ possibly come to a rational conclusion that LIBR could be applied, given the paucity of the information the parties provided to him? His only choice was to apply the *pari passu ex post facto* approach.

> 70 This Court recognizes that the Ontario Court of Appeal (as affirmed by the Supreme Court of Canada) applied the *pari passu ex post facto* approach in *Greymac*. That application, however, does not derogate from Morden JA's comment that although the *pari passu ex post facto* approach might be appropriate in some circumstances, he did not feel it would be appropriate "where the contributions to the mixed fund can be simply traced": *Greymac* at 16. Morden JA went on to say the following:
>
> > I am not persuaded that considerations of possible inconvenience or unworkability should stand in the way of the acceptance, as a general rule, of [LIBR]. That it is sufficiently workable to be the general rule is indicated by the fact that it appears to be the majority rule in the United States.
> >
> > *Greymac* at 17.
> >
> > See also *TD Bank* at para 32.
>
> 71 This Court recognizes that calculating entitlement to the Bank Account might be considered by some to be inconvenient and moderately complex. It is not, however, impossible to do the calculations. Inconvenience should not stand in the way of fairness.

Dismissing the appeal in *sub nom Easy Loan Corporation v Wiseman*, 2017 ABCA 58, the Alberta Court of Appeal confirmed that LIBR "is the fairest rule absent two exceptions (unworkability or the contrary intention of the beneficiaries) which we have concluded do not apply."

The "contrary intention" exception was discussed in *Greymac*, supra, and approved by the Alberta Court of Appeal in *Easy Loan*. *Greymac* states at para 53:

> Another exception, an obvious and necessary one ... would be the case where the court finds that the claimants have, either expressly or by implication, agreed among themselves to a distribution based otherwise than on a *pro rata* division following equitable tracing of contributions.". Blair J. also noted that it "is always open to a trust contributor to gain protection from having to share a shortfall with others by insisting upon the funds being placed in a separate trust account.": *LSUC* at para 27. Finally, in *Demystifying the Lowest Intermediate Balance Rule*, *supra*, Chamorro-Courtland wrote at 66-67 (emphasis in original):
>
> In summary, consideration must first be given to the express or implied contractual *intention* of the beneficiaries in the case of a shortfall in a commingled trust fund; the beneficiaries may opt for any distribution method that satisfies their business needs.
>
> If the contract is silent as to the method of distribution, the presumed intention, as the general rule, should be that the beneficiaries intended to segregate their funds and use LIBR. This is the presumption even in cases where the parties have opted to commingle their funds in an omnibus account, as it is possible to legally segregate the funds...

In *Re Graphicshoppe Ltd (2005)*, 260 D.L.R. (4th) 713, 78 O.R. (3d) 401 (C.A.), the impugned account included deposits other than those made by innocent beneficiaries. After the beneficiaries made all their contributions, the lowest balance of the account was, at one point, negative. Accordingly, the beneficiaries were precluded from the ability to trace their funds. The Ontario Court of Appeal noted at para 130:

> While this may seem harsh, it must be remembered that in the commercial context and particularly in the realm of bankruptcy, innocent beneficiaries may well be competing with innocent unsecured creditors for the same

> dollars. This raises policy considerations which the courts in *Greymac* and *LSUC* did not have to face.

The British Columbia Court of Appeal in *Tracy, supra*, considered unjust enrichment claims arising from thousands of loan transactions, the proceeds of which had travelled through various 'mixed' accounts such that they could no longer be reliably identified.

The court proceeded, at para. 37 *et seq*, to address "the fairness of providing the claimant in an unjust enrichment case with a proprietary interest that will prevail over the interests of ordinary creditors", noting as follows:

> The imposition of a trust may also be seen to work an injustice as between creditors in some instances. Thus Professor Paciocco in "The Remedial Constructive Trust: A Principled Basis for Priorities Over Creditors," 68 *Can. B. Rev.* 315 noted in 1989:
>
>> Goff and Jones have warned ... that [the rules regarding tracing into mixed funds] emerged in context of the equitable tracing remedy in order to prefer the beneficiaries to the bankrupt trustees' general creditors. Moreover, they emerged in the context of what were "pure proprietary claims". It has to be wondered whether they are truly appropriate in the context of remedial constructive trusts in the commercial context where concern for creditors may constitute a reason why such rules should not be employed. Dobbs has suggested that to allow the imposition of a remedial constructive trust in the absence of true identifiability is to work a preference for no good reason. Why should the law presume that the funds of the general creditors are dissipated before the funds of the constructive trust beneficiary? [At 337.]
>
> The author does conclude, however, that the "non-risk taking plaintiff" in an unjust enrichment action would normally have a higher claim to the property than general creditors, who have accepted the risk of being "simple debtors" of the defendant. (See also Leonard I. Rotman, "Deconstructing the Constructive Trust", (1999) 3 *Alta. L. Rev.* 133, at 165-170.)
>
> [38] In the present case, the analysis is perhaps less difficult, assuming that the granting of a constructive trust falls under the "broad umbrella of good conscience" (*Soulos,* para. 48). Here the plaintiffs assert a trust in order to pursue the very funds (and any funds or other assets into which they have been transformed) they paid to the defendants and the defendants received in contravention of the *Criminal Code*. Their claims are therefore qualitatively different from those of general creditors or other persons dealing with the defendants in the normal course. The unjust enrichment here is not only a private wrong, but arises from a criminal offence in respect of which it is in the public interest that neither the wrongdoers nor their ordinary creditors be permitted to retain the benefit.

V. Extending Remedy to Assets not Directly Traceable

Once the entitlement to a proprietary remedy has been established, a question may arise whether the charge can be extended over assets that are not traceable. The answer is generally no, but exceptions apply.

The possibility to extend a proprietary remedy to assets not traceable under classic tests was considered by the Privy Council, on appeal from the Court of Appeal of The Bahamas, in *Space Investments Ltd. v. CIBC Co. (Bahamas) Ltd.* [1986] 1 W.L.R. 1072 (P.C.) at 1074. The Court contemplated that where a bank trustee wrongly used trust funds for the general purposes of the bank, equity allowed the beneficiaries to trace the trust moneys to all assets of the bank and to recover the trust money by exercising an equitable charge over these assets in priority to the claims of both other customers with deposits and unsecured creditors. The rationale was based on the *dicta* of Sir George Jessel M.R. In *Re Hallett's Estate* (1880) 13 Ch. D. 696 at 719, that "[i]f a man mixes trust funds with his own, the whole will be treated as the trust property, …. that is, that the trust property comes first".

Ultimately, in *Space Investments* no equitable charge was available given a contractual provision which had authorized the deposit of the trust funds into the insolvent trustee's general accounts: there was "nothing to trace".

The concept considered in *Space Investments* was reconsidered, and rejected, by the English Court of Appeal in *Bishopsgate Investment Management Ltd (in Liquidation) v Homan,* [1994] 3 WLR 1270, in which the plaintiff was the trustee of certain assets of pension schemes out of whose funds money had been improperly paid into a bank account of another company, MCC. This bank account became overdrawn then was replenished. The plaintiff sought an equitable charge on all the assets of MCC. These claims were founded primarily on the foregoing observations in *Space Investments.* The Court of Appeal found that the *Space Investments* comments re: tracing to all assets were strictly *obiter*, and not concerned with a situation where trust moneys had been paid into an overdrawn bank account. Equitable tracing cannot be pursued through an overdrawn and therefore non-existent fund nor can misappropriated money be traced into an asset bought before the money was received by the purchaser. In this case, the alleged "replenishment" of the overdrawn trust fund had not occurred since there was no evidence of any intention that the new funds would be clothed with a trust in favour of the plaintiff. Overall the Court rejected in principle the concept that an equitable charge can be placed on assets which cannot be traced.

To similar effect, in *Barnabe v Touhey,* 1995 CanLII 1672, the Ontario Court of Appeal refused to apply the remedy of constructive trust over the general assets of departing partners of a law firm on the basis that there was no specific property which would be the subject of the trust.

The requirement in constructive trusts of "identifiable property to which the plaintiff contributed in some manner" imports the concept of tracing. In this regard, Newbury J.A. in *BNSF, supra,* applied the Federal Court of Appeal's reasoning in *Michelin Tires (Canada) Ltd. v. Canada* 2001 FCA 145 to establish the need to trace. In *Michelin Tires*, overpayments made by the plaintiff in respect of federal sales tax were held not to give rise to a constructive trust because the claimant was unable to identify "property in the hands of the defendant that is identifiable as the property, or its proceeds, that was transferred by or obtained from the plaintiff without a juristic reason, or that the defendant could not otherwise retain in good conscience." Evans J.A., for the Court, emphasized at para. 19 that a constructive trust "attaches to specific assets of the defendant that represent the enrichment; it is not a charge on the defendant's general assets for the amount of the plaintiff's claim." (emphasis added)

In family situations, the rules for tracing may be relaxed. In *Peter v Beblow* [1993] 1 SCR 980, Cory J. for the court, cited with approval Goff and Jones, *The Law of Restitution* (3rd ed. 1986), and extended the imposition of constructive trusts to situations where a plaintiff's contributions cannot be traced to a particular property. The court stated at 1020-1:

> It seems to me that in a family relationship the work, services and contributions provided by one of the parties need not be clearly and directly linked to a specific property. As long as there was no compensation paid for the work and services provided by one party to the family relationship then it can be inferred that their provision permitted the other party to acquire lands or to improve them. In this case the work of the appellant permitted the respondent to pay off the mortgage and, as well, to purchase a houseboat and a cabin cruiser. In the circumstances, the trial judge was justified in applying the constructive trust to the property which he felt would best redress the unjust enrichment and would treat both parties in a just and equitable manner. (emphasis added)

Another exception to the requirement to trace specific proprietary claims arises where funds are deposited into a trust account with the intention of replacing misappropriated trust funds. In such a case, the new funds are impressed with the same trust character that would have applied to the misappropriated funds: *Ontario (Director, Real Estate & Business Brokers Act) v. NRS Mississauga Inc.* (2003), 64 O.R. (3d) 97, 226 D.L.R. (4th) 361 (Ont. C.A.) at paragraph 49.

An example of this arose in *PricewaterhouseCoopers v Bank of Montreal, supra*, involving a realty company in receivership. The "Lump Sum", as therein defined, had been deposited into a trust account which had been totally depleted, with an intention to replace trust funds that had previously been removed. Since it was a replacement, it was not traceable to specific transactions. Based on the principle in *NRS Mississauga*, the Court concluded that the vendors and purchasers with proven but untraceable claims were entitled to benefit from a constructive trust over the Lump Sum and to have the Lump Sum divided among them *pro rata*. Effectively, the *pari passu ex post facto* approach was applied to assets which were deemed to be trust funds.

VI. Adequacy of pleadings

Claims for tracing should be pled carefully, as a plaintiff's claim will fail where he or she has not alleged the core requirements. Often, inadequate pleadings arise due to lack of knowledge of what has happened to the trust property, i.e. into what form it may have been converted. A beneficiary without access to banking records – whether of the original trust property or of accounts into which the original property has been paid – may be in no position to meet the test of specificity in its pleading. Similarly, if moneys have passed from a trust account through one or more further accounts or properties before finding their way into land as the ultimate destination, no amount of sleuthing and no number of land title searches may reveal the chain.

In *BNSF*, Newbury J.A. for the court declined to accept that a plaintiff must necessarily "in its pleadings, and without the advantage of evidence or findings of fact, demonstrate that a monetary award would be inadequate or inappropriate and point to "identifiable property" to which it contributed, before it may seek a declaration of constructive trust founded on a valid cause of action". The court held that there are circumstances in which a plaintiff may satisfy the two criteria for the finding of a constructive trust − i.e., demonstrate that a monetary award would be inadequate and identify property to which the plaintiff contributed in some manner − in the course of discoveries or trial, or be able to trace its funds into a mixed account or elsewhere, once the defendant's liability has been established." (emphasis added)

Pro-Sys Consultants Ltd. v. Microsoft Corporation, 2013 SCC 57, a case involving alleged contraventions of the *Competition Act*, R.S.C. 1985, c. C-34, demonstrates the importance of pleading the essential elements even where details are unknown. In *Pro-Sys*, the Supreme Court of Canada, while allowing the action to proceed on other grounds, struck a constructive trust claim due to inadequate pleadings.

Applying *Kerr, supra,* the court held that in order to find that a constructive trust is made out, the plaintiff must be able to point to a link or causal connection between his or her contribution and the acquisition of specific property. As the claim neither explained why a monetary award was inappropriate or insufficient nor showed a link to specific "referential" property, it did not satisfy the conditions necessary to ground a constructive trust. The claim was struck on the pleadings as it was plain and obvious that it could not succeed.

On the other hand, in *BNSF, supra*, the court found in para. 4 that "it may be incorrect to rule, before any facts have been found, that a constructive trust is "bound to fail" on the basis that the two criteria have not been satisfied in the plaintiff's pleading." In its pleading, the plaintiff claimed that the two defendants "had and received" some $14m and $3.8m, respectively, allegations subsumed under the rubric of restitution; that the defendants held those payments in trust for it; that the defendants were each enriched thereby; and that there was no juristic reason for the payments or their retention.

The defendants argued that the plaintiff's claim was bound to fail since there was no factual basis of either the inadequacy of damages or the existence of a "'link' between the contribution that [founded] that action and the property in which the constructive trust [was] claimed". Newbury J.A. disagreed and held that the necessary elements of a substantive trust had in fact been pled with respect to the claim for moneys had and received.

VII. Two-stage Trials

The decision in *Michelin Tires, supra,* suggests that once the link between the contribution and the property has been sufficiently pled, the Court may order an enquiry to determine if the required nexus has in fact been made out. Evans J.A. held:

> Thus, Lord Browne-Wilkinson did not suggest in *Westdeutsche Landesbank*, supra, that Goulding J. had erred in *Chase Manhattan*, supra, when he ordered an inquiry into whether the mistaken payment could be identified in the defendant's assets. Such an inquiry would only have been ordered if Goulding J. had thought that tracing was still required to determine the availability of a constructive trust.

While such a result might be considered contrary to the general rule against litigating in slices, and inherently risky, the Court of Appeal in *Tracy, supra,* affirmed that split trials can be a logical and efficient way of dealing with remedies where the facts and options may not be readily discernible from the outset.

The Court approved the trial judge's conclusion that, although the plaintiffs "could not receive double recovery, they were entitled to refrain from making an election until they were able to 'gauge which remedy [was] effective, particularly on the summary trial of common issues in a class proceeding.'"

> [47] The procedural implications of this entitlement were discussed in the Canadian context in the supplemental reasons in *Waxman v. Waxman*, supra. Under the heading "The Proper Tracing Sequence", the Court rejected the argument that having failed to call evidence at trial relevant to the tracing of certain assets, the plaintiffs should not be allowed to "cure the deficiency by gathering information and tracing in stages." The Court noted that if parties were required to call such evidence at trial, the cost and length of litigation would be greatly increased. The defendants were ordered to submit to cross-examination and discovery regarding their assets in order to permit the plaintiffs "to recover misappropriated trust funds after legal or equitable rights have been conclusively proved at trial." (Para. 44.)
>
> [48] Similarly in Island Records, the Court noted that where a plaintiff claims in the alternative damages or an accounting of profits, <u>the practice in England is to have a "split trial",</u> the first stage trying the issue of liability and the second, if liability is established, trying the question of assessment of damages and the calculation of profits. Lightman J. continued:
>
>> ... <u>As a concomitant with this practice, there has likewise developed the practice of limiting discovery at the first stage</u> to documents relevant to the issue of liability and excluding documents relevant only to the second stage. In this way the burden of discovery at the first stage is reduced, and the invasion of confidence necessarily involved in discovery is postponed and (if liability is not established) entirely obviated…
>
> [49] In my opinion, the same reasoning should apply in cases where damages and constructive trust are sought as alternative remedies... I need not decide whether, if the plaintiffs do not succeed in obtaining complete restitution by means of tracing, they may then revert to seeking damages.

In cases involving potential tracing, counsel should give consideration to the possibility of a split trial for a number of reasons. It may be premature at the outset for the plaintiff to gauge the appropriateness or desirability of tracing as an effective remedy. The evidentiary difficulties involved in tracing may not be a justifiable use of a party's or the court's resources before the court has determined whether the merits of the alleged proprietary claim have been established. Defendants may also resist disclosure of assets until such claim has been made out.

The critical step is to think through tracing as a possible remedy, and to ensure the necessary elements of any underlying proprietary claim have been adequately pled, along with the assertions necessary to establish a potential tracing. This may be done in the absence of information required to specify actual alleged destination accounts or properties, transfer dates, and other particulars which will ultimately need to be proven.

VIII. Conclusions

The following principles emerge from the authorities cited herein:

1. Claims of tracing are normally premised on establishing an equitable proprietary claim to identifiable assets. Claims may also be made to trace assets which are subject to a statutory remedy.
2. Claims cannot be traced into the hands of a *bona fide* purchaser for value without notice.
3. Except in family claims, plaintiffs with a proprietary claim to assets may not trace their claims preferentially over other creditors beyond the extent of funds or property demonstrably following from the proceeds of their original proprietary claim. The claim of the beneficiaries is prima facie limited to the lowest intermediate balance traceable into the account or property.
4. In family claims (and subject to applicable legislation), the rule is more fungible such that, so long as there was no compensation paid for the work and services provided by one party to the family relationship then it can be inferred that their provision permitted the other party to acquire or improve lands.
5. In a competition between trust claimants, the applicable method of distributing funds will depend on the intentions of the parties, as discerned, for example, from a contractual requirement to segregate.
6. Where no such intention is discernible, the general rule is pro rata sharing based on tracing, which says that a claimant cannot claim an amount in excess of the lowest balance in a fund subsequent to his or her investment and before the next claimant's investment is made. This is often simply expressed as the lowest intermediate balance rule or LIBR.
7. Since the LIBR rule is predicated on the various contributions to the mixed fund or property being readily identifiable at multiple points throughout the account's history, the *pari passu ex post facto* (or pooled accounts) approach will apply where that information is unavailable. That approach involves taking the claim or contribution of the individual beneficiary to the mixed fund as a percentage of the total contributions of all those with claims against the fund at the time of distribution, and multiplying that factor against the total assets available for distribution in order to determine the claimant's pro rata share of those remaining funds.
8. Tracing must be adequately pled by asserting the requisite proprietary base and link to property which is identified either specifically or generically, failing which the claim may be dismissed.
9. Tracing claims may, in appropriate cases, be the subject of split trials, being an exception to the so-called rule against litigating in slices.