THE LAW OF TRACING, Lionel D. Smith (Oxford: Clarendon Press, 1997)

The thorniest thicket into which a lawyer seeking a restitutionary remedy can tumble is "tracing," whereby the plaintiff seeks to locate the value of its asset which has fallen into the defendant's hands. The plaintiff's asset may have been passed on from a third party, or the defendant may have disposed of it in exchange for another asset; the question is whether the plaintiff can pursue the value of its lost asset through these exchanges. For this reviewer, scratched from several forays into this thicket, Lionel D. Smith's elucidation and rationalization of this ridiculously complicated area is welcome indeed.[1]

The book is a re-working of Smith's doctoral thesis, and was completed while he was still teaching at the University of Alberta Faculty of Law, before returning to Oxford to become a fellow of St. Hugh's College. In both analysis and style, the work shows the strong distinctive influence of its supervisor, Professor Peter Birks of All Souls' College, Oxford, whose ambitious project to organize and unify restitutionary principles has recruited several lawyers with Alberta connections.[2]

Smith's analysis fully incorporates Canadian and English cases and statutes and sets them in the context of law from elsewhere in the Commonwealth and from the United States. This makes it a particularly valuable reference for issues which commonly receive scanty treatment in legal texts addressing disparate specialist areas such as banking, securities, insolvency, property or family law. In particular, the detailed examination of a wide range of contentious technical issues such as tracing through bank accounts or electronic fund transfers make it an indispensable acquisition for law firms specializing in commercial and banking law.

The maze of complex and even impenetrable rules devised by the competing systems of the common law and equity can thwart the hapless claimant who can see his goal but cannot find the way to reach it. Modern courts have recognized this but by and large have been reluctant to cut paths through received doctrines. The radical thesis underpinning this book is that there is a single set of rules for tracing value, and thus it is fallacious to speak of "tracing at common law" or "tracing in equity." This conclusion requires three bold analytical steps.

First, Smith insists on the necessity of segregating the exercise of identifying assets from establishing the claimant's entitlement to those assets once identified. Following or tracing the claimant's missing asset into the hands of a third party or to a substituted asset is simply a process, albeit governed by some legal rules. Smith asserts that equity and the common law diverge only after that exercise is complete, to determine whether the claimant is entitled to a remedy relating to the identified asset, and if so, the nature of that remedy.

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1 L.D. Smith, *The Law of Tracing* (Oxford: Clarendon Press, 1997).

2 Another example being Robert Chambers' *Resulting Trusts* (Oxford: Clarendon Press, 1997).

Next, Smith destroys the twin shibboleths which have shackled the ability of equity and common law to trace. It has long been assumed that a prerequisite to tracing in a court of equity is the establishment of a fiduciary relationship between the defendant and the claimant. This assumption was recently confirmed by the English Court of Appeal in *Agip (Africa) Ltd.* v. *Jackson.*[3] While Smith is not the first academic to debunk this myth, his demonstration of the illogicality of the purported rule and his dissection of the ostensible authority for it should dispel any lingering doubts. He contends that the only prerequisite to tracing is a common law or equitable right in the original asset. The role of the fiduciary relationship should be relegated to determination of whether a claimant who has successfully traced is entitled to an equitable proprietary interest in the end product, not whether he or she can locate that end product in order to assert a claim. Smith doubts whether even this residual role is necessary.

The second impediment to a unified tracing system is the rule supposedly decreed in *Taylor* v. *Plumer*[4] that the common law cannot trace into a "mixed fund," whereas equity can. Smith establishes that this rule is an artifact of untenable reasoning and an incremental misinterpretation of authority. Not only does the perceived limitation conflate the process of tracing and adjudication of whether the claimant has a right to its product, but the seminal case dealt with equitable rather than common law proprietary rights.

By removing these wheel clamps on tracing in equity and the common law, Smith has enabled tracing to be a more effective vehicle in conveying dispossessed plaintiffs towards a remedy. Smith's objectives in offering a new synthesis of the principles of tracing are to establish internal rationality, uniformity between equity and the common law, and justice amongst the various parties involved in the tracing matrix. So what does this unified system look like?

Smith bifurcates the identification process into two analytically distinct mechanisms. "Following" is a relatively straightforward technique whereby the claimant identifies his/her original tangible asset in the hands of another party. Provided the asset remains in a form in which it is still identifiable as the original thing, the claimant may follow it through a chain of recipients. Thus if a thief gives my stereo to his daughter, I can follow my stereo through the transaction to the hands of the daughter. "Tracing" is more complex, because it allows the claimant to identify a new thing which has been substituted for the claimant's original asset. What the claimant is chasing is the value represented by the original asset, as it has been transformed through the substitution into a new thing. Thus if the daughter sells my stereo for $200, I can follow the stereo into her hands, and then trace through the exchange transaction the sale proceeds of $200.

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3 [1991] Ch. 547 at 566.

4 (1815) 3 M. & S. 562, 105 ER 721.

Many authors, such as the leading Canadian commentators on the law of restitution, Maddaugh and McCamus,[5] subsume following within tracing. Paradoxically, Smith's technique of treating the two mechanisms as separate and distinct facilitates the creation of a unified system, because their parallel approaches to problems such as mixtures of assets and claims against wrongdoers are highlighted.

The principal problem when following is locating the plaintiff's asset when it has been mixed with other similar substances (for example, where the claimant's wheat has been mixed with other wheat in a grain elevator). The problem is essentially one of identification of the claimant's asset, particularly where the mixture has been divided or reduced, and it is impossible to say whose contribution has been withdrawn. The courts have devised necessarily artificial but pragmatic rules to bridge these evidential gaps. In essence, a claimant who is not responsible for wrongdoing in relation to the mixture can assert that his/her contribution exists in any part of the mixture which remains, subject to the right of other contributors to do the same. Where the mixture has been reduced, the loss will be borne by the contributors in proportion to their contribution. The upper limit is always the amount of the original contribution by that party; conversely, a party's ability to follow is limited by the lowest balance which has existed in the mixture since that contribution was made. The rules that all contributors have equal rights to follow, and that everyone suffers equally from any shortfall, do not apply in favour of a wrongdoer. However, Smith disputes *dicta* suggesting that the wrongdoer is barred from asserting any interest in the mixture. He contends that forfeiture of the wrongdoer's claim occurs only where it is impossible to quantify the respective parties' contributions to the mixture, in which case the whole mixture is assumed to have come from the innocent parties. Where the wrongdoer can prove that he or she did contribute to the mixture, then his/her ability to follow that contribution is not destroyed, but is subordinated to the rights of any other contributor. Thus any shortfall in the mixture will be counted against the wrongdoer, whose claim cannot be met until all the innocent contributors' claims have been satisfied.

These themes of equal rights amongst innocent claimants and the subordination of the claims of wrongdoers, developed for following contributions into physical mixtures, have been transplanted to the exercise of tracing into mixed funds or "mixed substitutions." This arises where the claimant's original value has become inextricably mixed with another's value in the new asset. The problems are particularly vexatious in relation to tracing through bank accounts, which are characterised as indistinguishable mixtures of value, making it impossible to say which part originally belonged to any claimant. Banking lawyers will be intrigued by the lucid and comprehensive discussion of these very difficult issues, which hark back to the venerable rule of "first in first out" in *Clayton's Case*.[6] Smith shows that the "first in first out" rule should not apply to tracing by a third party out of a bank account. Instead, by analogy with physical mixtures, a contributor to the bank account should be at liberty to assert his/her interest in any part of the mixture, including the right to

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5 P.D. Maddaugh & J.D. McCamus, *The Law Of Restitution* (Aurora: Canada Law Book Inc., 1990) at 110-21.

6 (1816) 1 Mer. 529.

claim that part of his/her value has been withdrawn and to trace that money further along the chain. Only after the contributor's share is determined can the wrongdoer claim any interest in the account or its proceeds.

The law of tracing has had particular difficulty accommodating the movement of value through modern financial institutions, such as transfers of electronic funds, and credit and debit card payments. Smith dubs this "tracing in transit," where payments are made through intermediaries in the chain. Sir Peter Millett has suggested that tracing at common law is impossible because of "mixing" in the payment clearing system, but that cheques can still be traced because the clearing system can be bypassed.[7] Smith convincingly argues that the common law is not stymied by such systems, and that all such payment systems are amenable to tracing. The mode of settlement of an obligation is irrelevant because the claimant is not tracing the money itself, but merely the right of the customer to payment from the bank. All that is required is to show that the payee's receipt of credit or cash from the transaction is the traceable product of value in the payor's bank account. He subjects securities to the same detailed analysis, and also finds the perceived impediments to tracing generally lack substance.

At the end of the tracing analysis, Smith concludes that equity and the common law take a common approach to following and tracing. Both systems subordinate the interests of wrongdoers in the same way and are willing to treat all other claimants equally. The common elements of these systems allow fictitious legal presumptions to be replaced by pragmatic rules which accommodate the competing interests of all players in the identification process. Quite apart from the merits of his arguments that current dogmas have been constructed on flawed foundations, this result must be right. A victim's ability to trace through a rogue's bank account should not be blocked because he was bilked by a stranger rather than, for example, by his lawyer. Judges should not be forced by abstruse relics of an obsolete division of jurisdictions to "read equity backwards"[8] to fashion fiduciary relationships *ex post facto*, just to allow a plaintiff to benefit from the wider scope of tracing powers thought to be held in equity.

Having stripped the tracing exercise clean of the clutter of common law and equitable doctrines, the issues surrounding the claimant's equitable or common law entitlement to the tracing proceeds are found under the general head of "Claiming." The most crucial question is whether the common law or equity will allow the claimant to assert a proprietary claim in the new asset which has been substituted for the original one. This has important implications for the defendant's unsecured creditors, as well as any third party who may have acquired the asset. Here, Smith notes the recent significant divergence between North American courts on one hand, which have readily deployed equitable remedies in new territory, and other common law courts on the

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7 *Agip (Africa) Ltd.* v. *Jackson*, [1990] Ch. 264 at 286, aff'd on this point [1991] Ch. 547 at 566 (C.A.); Sir Peter Millett, "Tracing Of the Proceeds Of Fraud" (1991) 107 L.Q.R. 71 at 73.

8 To adopt the pithy phrase of La Forest J. in *LAC Minerals Ltd.* v. *International Corona Resources Ltd.*, [1989] 2 S.C.R. 574 at 652.

other which adhere to traditional boundaries due to "a well-intentioned but misconceived doctrinal conservatism."[9]

Conversely, Smith contends that the development of common law remedies should not be neglected in favour of their alluring but potentially too powerful equitable cousins. In this context he explores the possibility that a limited common law proprietary right might be created where value has been transferred from the plaintiff through a third party to the defendant, in such a way as to extinguish the plaintiff's full ownership (for example where the plaintiff's money has been traced through the third party's bank account). The fact that an action for money had and received lies against the defendant implies a residual proprietary right vested in the plaintiff.[10]

When analyzing the specific remedies to be attached to traced proceeds, Smith may seem to raise more questions than he answers. Sometimes he is somewhat tentative in selecting a preferred solution. However, he maps out and evaluates the competing arguments in largely unexplored territory, which will be a valuable source for lawyers arguing these issues.

For the practising lawyer, the book's value as a rapid reference to clear up sticky points is limited, because it is structured as a detailed cumulative analysis to construct a coherent system of principles. The search for internal consistency requires that contentious topics be analysed by analogy with areas more populated by case law. This is a valuable strategy where the objective is to rationalize an area of law fraught with contradictions, confusion and misunderstanding of the jurisprudence. It would be unfortunate if a busy practitioner searching for a quick answer is deterred from delving into Smith's elegant and meticulous arguments. While the introductory chapter, entitled "Foundations", provides a valuable overview of the issues, those in search of solutions to specific problems would have been assisted by a concluding chapter providing a synopsis of the principles of Smith's unitary tracing system and the rights which the common law and equity may allow a tracing claimant to assert. This would help pinpoint established and contentious principles and alert browsing readers to important but often overlooked questions examined in the foregoing chapters. As it is, the book ends abruptly with a discussion of the relatively narrow point of pooled investments which have failed, without any attempt to pull the camera back from technical detail to survey the picture which has emerged. However, this is a minor quibble about a work which is magisterial in its breadth and depth of research (often reaching far beyond standard legal materials) and lucidity of exposition of a wide variety of complex and often technical issues.

Lionel Smith's central contention that there is a single set of tracing rules may be subject to challenge on the basis that it does not reflect present judicial thinking. But whether Smith's picture accurately reflects the current state of the law is quite a different question from whether his picture portrays what the law should be. He

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9 Smith, *supra* note 1 at 284.

10 This is Smith's explanation for the result in *Lipkin Gorman* v. *Karpnale Ltd.*, [1991] 2 A.C. 548 (H.L.); see Smith, *ibid.* at 332-39.

constructs a compelling case that the lingering differences between common law and equity should be jettisoned as unjustifiable artifacts of competing jurisdictions tackling the same problems with different tools, neither with complete success. Under this revamped unitary system, the exercise of tracing or following would be much more widely available to claimants. Since the identification exercise is essentially neutral, this result cannot be seriously attacked on policy grounds. That said, the analytical segregation of the identification exercise from the subsequent adjudication of claims will in turn compel courts to confront directly the extraordinarily difficult policy issues underlying the claimants' entitlement to traceable proceeds. It is doubtful that other Commonwealth jurisdictions will approach the remedial questions with the same insouciance toward the boundaries of equity and the common law which the Supreme Court of Canada has evinced, for example through the device of the remedial constructive trust. But at least now courts cannot evade direct discussion of the competing claims to the end product of the tracing exercise by artificially blocking the identification process.

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