SASKATCHEWAN LAW REVIEW

The Death and Resurrection of the Lowest Intermediate Balance Rule

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I. INTRODUCTION

The lowest intermediate balance rule is part of the law of tracing. In *Agricultural Credit Corp. of Saskatchewan v. Pettyjohn*,[1] the Saskatchewan Court of Appeal defined tracing as follows:

> [Tracing] involves following an item of property either as it is transformed into other forms of property, or as it passes into other hands, so that the rights of a person in the original property may extend to the new property. In establishing that one piece of property may be traced into another, it is necessary to establish *a close and substantial connection* between the two pieces of property, so that it is appropriate to allow the rights in the original property to flow through to the new property.[2]

For example, if a trustee sells trust property, tracing enables the beneficiary to follow her interest into the sale proceeds, and to assert that the trustee holds the proceeds on trust for the beneficiary. On the same basis, if the trustee banks the proceeds, tracing enables the beneficiary to follow her interest into the bank deposit. Where the proceeds become mixed with other funds in the account, belonging to either the trustee or a third party, the law of tracing has rules to help identify the portion of the mixed fund to which the beneficiary is entitled. The lowest intermediate balance rule applies where the mixed fund is depleted between the date the sale proceeds are deposited and the date of the dispute. The rule states that "a claimant to a mixed fund cannot assert a proprietary interest in that fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to

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1 79 DLR (4th) 22, [1991] 3 WWR 689 (Sask CA) [*Pettyjohn* cited to DLR].
2 *Ibid* at 39 [emphasis added].

that contribution is being made against the fund."[3] In the *LSUC*[4] case, Justice Blair (*ad hoc*) described the rationale for the rule as follows:

> [The] concept is grounded, ultimately, on the premise that tracing rights are predicated upon the model of property rights. [The lowest intermediate balance rule] seeks to recognize that at some point in time, because of earlier misappropriations, an earlier beneficiary's money has unquestionably left the fund and therefore cannot physically still be in the fund. Accordingly, it cannot be 'traced' to any subsequent versions of the fund that have been swollen by the contributions of others, beyond the lowest intermediate balance in the fund.[5]

The lowest intermediate balance rule was first stated in *James Roscoe (Bolton) Limited v. Winder*,[6] and has become an established part of the law in England and most parts of the Commonwealth.[7] But in the *LSUC* case, the Ontario Court of Appeal cast doubt on the rule's application in Canada and the uncertainty was exacerbated by Justice Lax's decision in *Graphicshoppe Ltd. (Re)*.[8] A measure of orthodoxy was restored with the Ontario Court of Appeal's reversal of Lax J.'s decision,[9] and the return to normalcy appears to have been completed with Justice Morawetz's decision in *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* (affirmed by the Ontario Court of Appeal).[10]

This paper is in celebration of Professor Ronald Cuming's long and outstanding contribution to commercial law and, in particular, secured transactions law, in Canada and internationally. The principles of tracing are typically associated with the law of trusts, which is not prominent in Professor Cuming's extensive repertoire.[11] Although

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3 *Law Society of Upper Canada v Toronto-Dominion Bank* (1998), 169 DLR (4th) 353 at para 14, 42 OR (3d) 257 (CA), Blair J [*LSUC*].

4 *Supra* note 3.

5 *Ibid* at para 19.

6 [1915] 1 Ch 62 [*James Roscoe*].

7 For a recent reaffirmation of the rule, see *Federal Republic of Brazil v Durant International Corporation*, [2015] UKPC 35 (on appeal from Jersey).

8 (2004), 74 OR (3d) 121, 6 CBR (5th) 176 (Sup Ct) [*Graphicshoppe* Sup Ct].

9 *Graphicshoppe Ltd. (Re)* (2005), 260 DLR (4th) 713, 78 OR (3d) 401 [*Graphicshoppe* CA].

10 *Boughner v Greyhawk Equity Partners Limited Partnership (Millenium)*, 2012 ONSC 3185, 111 OR (3d) 700 [*Boughner*], aff'd 2013 ONCA 26, 5 CBR (6th) 113.

11 But see Ronald CC Cuming, "Protecting Interests in Proceeds: Equity and Canadian Personal Property Security Acts" in Donovan Waters, ed, *Equity, Fiduciaries and Trusts* (Scarborough: Carswell, 1993) 423 at 423.

most of the cases on tracing and the lowest intermediate balance rule have been trusts cases, the principles are not limited to cases where the claimant is a beneficiary under a trust. In particular, they also apply in the Personal Property Security Act ("PPSA") context, where the claimant holds a security interest and there is a dealing in the collateral. The PPSAs provide that where collateral gives rise to proceeds, the security interest extends to the proceeds and they define "proceeds" to mean "identifiable or traceable personal property."[12] It has been held that these provisions incorporate the principles of tracing into the PPSAs.[13]

The purpose of this paper is to explore the to-ings and fro-ings of the Ontario courts in the cases mentioned above, to identify the current status of the lowest intermediate balance rule in light of these cases, and to explore some of the cases' implications in the PPSA context. The paper is structured as follows. Part II identifies different fact patterns in the trusts context where the lowest intermediate balance rule may be in issue, drawing attention in particular to the distinction between cases where the dispute is between the trustee and the beneficiary, and cases where the dispute is between two or more beneficiaries. Part III discusses the Ontario line of cases in more detail. Part IV explores some implications of the Ontario cases in the PPSA context. Part V concludes.[14]

II. APPLICATIONS OF THE LOWEST INTERMEDIATE BALANCE RULE

A. INTRODUCTION

As indicated in Part I, the lowest intermediate balance rule applies in cases where the claimant's property has become mixed with property belonging to another party, for example, where the claimant's money becomes mixed with other funds in a bank account. The two main kinds of case in the trusts context are: (1) where the other funds belong to the trustee; and (2), where the other funds belong to a second beneficiary. A variation on these two scenarios is where both the trustee and a second beneficiary have claims on the account. What follows is an account of the law applicable in each of these scenarios, leaving aside for the moment the Ontario cases which will be returned to in Part III.

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12 See e.g. *The Personal Property Security Act, 1993*, SS 1993, c P-6.2, ss 28(1), 2(1)(hh) ("proceeds") [Saskatchewan *PPSA*].

13 *Pettyjohn*, *supra* note 1 at 42-43.

14 The paper is an updated and substantially revised and expanded version of Anthony Duggan, "Tracing, Canadian-Style: *Re Graphicshoppe* and Other Recent Cases" (2006) 43:2 Can Bus LJ 292.

B. TRUSTEE-BENEFICIARY DISPUTES

Example 1

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T deposits $500 of T's own money. On Date 3, T withdraws $800, leaving $700 in the account. On Date 4, B discovers T's wrongdoing. On Date 5, T becomes bankrupt. There are no further movements in the account after Date 3. Can B claim some or all of the $700 remaining in the account?

The answer depends on whether T's Date 3 withdrawal is debited against the Date 1 deposit of B's money or the Date 2 deposit of T's own money. In the absence of a contrary agreement between the parties, one approach might be for the court to apply the rule in *Clayton's Case*[15] (the "first in, first out rule").[16] On this basis, withdrawals are debited against deposits in the order the deposits were made. Applying the rule to the facts of Example 1, the withdrawal is debited against the Date 1 deposit of B's money, with the result that, of the $700 remaining in the account, $200 represents B's money and the balance goes to T's estate. But in *Re Hallett's Estate*,[17] the Court refused to apply the rule in *Clayton's Case* in circumstances similar to Example 1 because the rule is arbitrary: the parties' relative entitlements depend entirely on the order of the deposits. Instead, the Court applied a presumption of rightful withdrawal, leading to the conclusion that T intended to make the Date 3 withdrawal against T's own money. Applying this approach to the facts of Example 1, B is entitled to the whole $700 remaining in the account and the court will make an order declaring a charge on the fund in B's favour or, alternatively, declaring that T (or rather, T's trustee in bankruptcy) holds the money on trust for B.

Example 2

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T deposits $500 of his own money. On Date 3, T withdraws $800, leaving $700 in the account. On Date 4, T deposits $300, again T's own money, taking the account balance up to $1,000. On Date 5, B discovers T's wrongdoing. On Date 6, T becomes bankrupt. There are no further movements in the account after Date 4.

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15 *Devaynes v Noble, Clayton's Case* (1816), 1 Mer 529, 35 ER 767 (Rolls Ct) [*Clayton's Case* cited to ER].

16 *Ibid* at 781.

17 *Re Hallett's Estate; Knatchbull v Hallett* (1880), 13 Ch D 696 (CA) [*Re Hallett's Estate*].

According to the rule in *Re Hallett's Estate*, B has a claim on the account for at least $700 (as in Example 1). But the question is whether B can claim the full $1,000 now in the account. Applying the lowest intermediate balance rule, the answer is "no": B's claim is limited to the lowest balance in the account between the Date 1 deposit and the date of B's claim on the fund. As indicated in Part I, above, B's claim depends on being able to trace her interest in the original funds to the money now in the account, and the right to trace depends on being able to establish a "close and substantial connection" between the two assets. T's Date 4 deposit has no connection with the $1,000 T misappropriated from the trust and so B cannot rely on the tracing rules to claim those funds. The point can be demonstrated as follows: assume T had not made the $300 Date 4 deposit, but instead had left the cash in a drawer at home. Would B have had a claim to the $300 lying in the drawer? The answer is clearly "no," and there is no reason why B should magically acquire a claim to the money just because T elects to deposit it instead.[18] Lionel Smith states the principle as follows:

> [T]he concept of tracing...is the finding of transactional links between one asset and another. A court can only dispense with the [lowest intermediate balance] rule if it is willing to discard a fundamental part of the Western legal tradition, namely that your losses are yours and my assets are mine.[19]

In this context, in cases like Example 2, the courts have refused to treat T as having made the Date 4 deposit with the intention of replenishing the trust funds, unless T specifically made the deposit for this purpose.[20] In other words, at least for the purposes of the law

18 Lionel Smith, "Tracing in Bank Accounts: The Lowest Intermediate Balance Rule on Trial" (2000) 33:1 Can Bus LJ 75 at 80. See also *Brookfield Bridge Lending Fund Inc. v Karl Oil and Gas Ltd.*, 2009 ABCA 99 at para 15, [2009] 7 WWR 1, quoted with approval in *Easy Loan Corporation v Wiseman*, 2017 ABCA 58 at para 25, 45 Alta LR (6th) 209 [*Wiseman*]:

> [T]he real reason for allowing the claimant to reach the balance [of the mixed fund] is that he has an equitable interest in the mingled fund which the wrongdoer cannot destroy as long as part of the fund remains; but there is no reason for subjecting other property of the wrongdoer to the claimant's claim any more than to the claims of other creditors merely because the money happens to be put in the same place where the claimant's money formerly was, unless the wrongdoer actually intended to make restitution to the claimant.

19 Smith, *ibid* at 91.

20 *James Roscoe*, *supra* note 6 at 69. If T did make the deposit with the specific intention of replenishing the trust funds, the transaction might be open to challenge as a preference (*Bankruptcy and Insolvency Act*, RSC 1985, c B-3, s 95 [*BIA*]).

of tracing, the courts treat a bank account "not as a single asset but, rather, a series of payments and withdrawals, the identity of each of which can be traced."[21] As Example 2 indicates, the tracing issue typically arises where the trustee is insolvent so that the beneficiary's claim on the account is in competition, not with the trustee himself, but with the claims of the trustee's unsecured creditors. The lowest intermediate balance rule aims to prevent the beneficiary's tracing rights from encroaching too far on the rights of unsecured creditors.[22]

C. BENEFICIARY-BENEFICIARY DISPUTES

Example 3

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T deposits $500 which T holds on trust for a different beneficiary, B1. On Date 3, T withdraws $800, leaving $700 in the account. On Date 4, B and B1 discover T's wrongdoing. On Date 5, T becomes bankrupt. There are no further movements in the account after Date 3.

The difference between this case and Example 1 is that here T's Date 2 deposit is not T's own money, but funds belonging in equity to B1. None of the funds in the account belong to T and so neither T nor T's estate has any claim on the account. Rather, the competition for the $700 left in the account is between B and B1. The rule in *Re Hallett's Estate* has no application here because it is tailored specifically to disputes between the wrongdoer and the wrongdoer's victim. A court might fall back on the rule in *Clayton's Case* to determine B and B1's relative entitlements, but the rule is unattractive in a setting like Example 3 because it is arbitrary. Under the rule in *Clayton's Case*, B1 prevails because T's Date 3 withdrawal is debited against the Date 1 deposit of B's funds but, if the order of the deposits were reversed, the result would be the opposite. In *Ontario (Securities Commission) v. Greymac Credit Corp.*,[23] the Ontario Court of Appeal held that given the arbitrariness of the rule in *Clayton's Case*, as a general rule it should not be applied in beneficiary-beneficiary disputes and, instead, the court should apply a *pro rata* sharing rule. Applying this approach to the facts of Example 3, B and B1 share the $700 closing account balance in proportion to their respective contributions to the fund—in other words, 2:1.

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21 Richard Calnan, *Proprietary Rights and Insolvency*, 2nd ed (Oxford: Oxford University Press, 2016) at para 8.194.

22 *Ibid* at paras 8.151, 8.196.

23 (1986), 30 DLR (4th) 1, 55 OR (2d) 673 (CA) [*Greymac*], aff'd [1988] 2 SCR 172, 52 DLR (4th) 767.

Example 4

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T withdraws $800, leaving $200 in the account. On Date 3, T deposits $500 which T holds on trust for B1, taking the account balance up to $700. On Date 4, B and B1 discover T's wrongdoing. On Date 5, T becomes bankrupt. There are no further movements in the account after Date 3.

This case is like Example 2, except that here the $500 T deposits is not T's own money, but belongs in equity to B1. The case also resembles Example 3, in that the dispute is between two beneficiaries, rather than between a beneficiary and the wrongdoer's trustee in bankruptcy. Given the latter connection, it might be tempting to think that B and B1 share the $700 *pro rata*, as in Example 3. In principle, however, the analysis should be the same as in Example 2: B's claim on the $700 depends on the ability to trace, which in turn depends on there being a close and substantial connection between its interest in the original funds and the money left in the account. There is no such connection between B's original entitlement and T's Date 3 deposit. B's claim on the account dropped to $200 following T's Date 2 withdrawal and so, applying the lowest intermediate balance rule, this is the limit of B's entitlement; the remaining $500 goes to B1.[24]

D. MIXED BENEFICIARY-BENEFICIARY AND BENEFICIARY-TRUSTEE DISPUTES

Example 5

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T deposits $500 which T holds on trust for B1. On Date 3, T withdraws $800, leaving $700 in the account. On Date 4, T deposits $300 of T's own money, taking the account balance up to $1,000. On Date 5, B and B1 discover T's wrongdoing. On Date 6, T becomes bankrupt. There are no further movements in the account after Date 4.

Example 5 has elements of both Examples 2 and 3. Applying the lowest intermediate balance rule, as in Example 2, neither B nor B1 have a claim on the funds represented by T's Date 4 deposit. The

24 See Donovan WM Waters, Mark R Gillen & Lionel D Smith, *Waters' Law of Trusts in Canada*, 4th ed (Toronto: Carswell, 2012) at 1351.

result is that $300 of the closing account balance goes to T's estate. Applying the *pro rata* sharing rule, as in Example 3, B and B1 share the remaining $700 in the proportions 2:1.

Example 6

> On Date 1, T misappropriates $1,000 from funds T holds on trust for B and deposits the money in T's personal bank account. On Date 2, T deposits $500 which T holds on trust for B1. On Date 3, T deposits $200 of T's own money. On Date 4, T withdraws $1,000, leaving $700 in the account. On Date 5, B and B1 discover T's wrongdoing. On Date 6, T becomes bankrupt. There are no further movements in the account after Date 4.

Example 6 has elements of Examples 1 and 3. Applying the rule in *Re Hallett's Estate*, as in Example 1, T's Date 4 withdrawal is in the first instance debited against T's own contribution to the account (the $200 Date 3 deposit). The result is that T's trustee in bankruptcy has no claim on the $700 closing account balance. Applying the *pro rata* sharing rule, as in Example 3, B and B1 share these funds in the proportions 2:1.

III. THE ONTARIO CASES

A. THE *LSUC* CASE

1. The Facts

A solicitor, over time, misappropriated more than $900,000 he was holding for clients in a trust account with the Toronto-Dominion Bank. The final misappropriation, on 24 September 1991, left a balance of $66,242.68. On September 25, 1991, the bank deposited $173,000 into the account. The money was intended as a mortgage loan for one of the solicitor's clients. The account was frozen before the transaction could be completed. On October 2, 1991, the bank unilaterally withdrew the $173,000 and paid it over to another solicitor to complete the transaction. The Law Society applied to the court for directions. The bank's withdrawal was arguably improper, but to avoid litigation on the issue, the bank agreed that the case should be determined on the basis least favourable to it, namely that the withdrawn funds were still in the account. The question for the court was what claims did the bank and the solicitor's defrauded clients have to the money in the account on the date the account was frozen?[25]

25 *LSUC*, *supra* note 3 at paras 1-6.

2. The Decision

The facts resembled Example 5, above, and the analysis of that case suggests that the proper approach is to apply the lowest intermediate balance rule in the bank's favour, leaving the beneficiaries to share *pro rata* in the remainder. But in the *LSUC* case, the trial judge refused to apply the lowest intermediate balance rule and held instead that the funds in the account, including the bank's September 25, 1991 deposit, should be shared *pro rata* between the bank and the beneficiaries. The Court of Appeal upheld this decision. Blair J. wrote the judgment.

The main grounds for the decision were as follows. First, Blair J. treated the *Greymac* case as authority for the proposition that in a beneficiary-beneficiary dispute, "*pro rata* sharing based on the respective property interests of the claimants in the total amount of trust money or property available, should be applied."[26] Second, and relatedly, he noted the Court's rejection in *Greymac* of the rule in *Clayton's Case* and pointed out that the application of the lowest intermediate balance rule on the present facts would in effect reintroduce the rule in *Clayton's Case* by the back door: it would "permit the Bank—the last contributor—to recover what for all practical purposes is all of its deposit."[27] Third, he denied the property-based theory of tracing, stating that "the issue whether this proprietary remedy must be inflexibly tied to a pre-existing proprietary right—i.e., the purely logical application of tracing rules—is an important question…[but] in circumstances such as this, they need not be inflexibly tied together."[28] Fourth, he held that the application of the lowest intermediate balance rule in the present case would involve complex calculations, whereas the *pro rata* sharing rule has the virtue of simplicity.[29] Fifth, he regarded the *pro rata* sharing rule as inherently fairer than the lowest intermediate balance rule because it "spreads the misappropriations rateably amongst the contributors who remain, but at the same time does not arbitrarily affect earlier contributors adversely by limiting their charge or constructive trust to the lowest balance in the account."[30]

3. Discussion

The decision is open to question on several counts. First, as Morawetz J. was later to demonstrate in *Boughner*, it is based on a misreading of *Greymac*. This point is developed in Part III-C, below. Second, the

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26 *Ibid* at para 13.
27 *Ibid* at para 9.
28 *Ibid* at para 28.
29 *Ibid* at paras 34-40.
30 *Ibid* at para 41.

judgment is cavalier in its rejection of the property-based theory of tracing. To repeat Smith's words: "A court can only dispense with the [lowest intermediate balance] rule if it is willing to discard a fundamental part of the Western legal tradition, namely that your losses are yours and my assets are mine."[31] Smith goes on to say: "Any court that takes that step must stand ready to articulate the principles according to which it will redistribute the assets of litigants."[32] There is no such articulation of principles in Blair J.'s judgment. The judgment rests instead on broad appeals to convenience and fairness. But the convenience argument reduces to the proposition that ease of administration trumps property rights, while the fairness argument abstracts from the property-based theory of tracing and so is also a denial of property rights.[33] Blair J.'s judgment is consistent with the idea that a bank account is a single asset, the amount of which varies from time to time, while, as indicated earlier,[34] the lowest intermediate balance rule treats each deposit and withdrawal as a separate transaction, the identity of which can be traced.[35] The single asset theory may be a more accurate description of how the modern bank account works, but it does not require slavish adherence. In particular, as the *LSUC* case itself demonstrates, applying the theory in the tracing context has serious implications for third party property rights.[36]

On its face, the *LSUC* case stands only for the proposition that in a beneficiary-beneficiary dispute, a court may decline to apply the lowest intermediate balance rule if the calculations would be too complex and instead may apply the *pro rata* sharing rule. But the implications of the judgment are much broader than this. The case could be read as authority for the proposition that the lowest intermediate balance rule never applies in beneficiary-beneficiary disputes. It could also be read as suggesting that the lowest intermediate balance rule does not apply in trustee-beneficiary disputes either. In particular, the Court's rejection of the property-based theory of tracing seems equally relevant in this context. In summary, on a broad reading, the *LSUC* case hints at the total abolition of the lowest intermediate balance rule. This reading of the case is supported by Lax J.'s decision in *Graphicshoppe* Sup Ct, to which attention will now be turned.

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31 *Supra* note 18 at 91.
32 *Ibid*.
33 *Ibid*.
34 See the text accompanying note 19.
35 In the *LSUC* case, Blair J. discussed this distinction at some length, referring to the two approaches as "the fund as a blend" approach and the "fund as an amalgam" approach, respectively. In the end he accepted and adopted the fund as a blend approach (*supra* note 3 at paras 41-50).
36 See Calnan, *supra* note 21 at paras 8.150-8.151, 8.193-8.207.

B. *GRAPHICSHOPPE*

1. The Facts

A company, Graphicshoppe, defaulted on remitting employee contributions to its employee pension plan, which it had deducted at source. The amount in question came to approximately $93,000. These funds were held for a time in the company's general operating account, but by the time of the action, they had long been spent and at some point the account balance dropped to zero or below. Graphicshoppe went into bankruptcy with approximately $145,000 in its account. The $145,000 closing balance was money Graphicshoppe had received from another company, Textron, in payment for discounted receivables.[37] The employees, relying on both the deemed trust provisions in the *Pension Benefits Act*[38] and common law principles, asserted a trust in their favour over the funds in the account. Graphicshoppe's trustee in bankruptcy argued that the lowest intermediate balance rule applied, with the result that the employees had no claim on the Textron deposit and the funds belonged instead to the estate.[39]

2. The Decision

The facts resemble Example 2, above, and the analysis of that case points to the application of the lowest intermediate balance rule. But in *Graphicshoppe* Sup Ct, Lax J., relying on the *LSUC* case, held that she was not required to apply the lowest intermediate balance rule but was "bound to search for the method of allocating the loss which is the more just, convenient and equitable in the circumstances."[40] In the present case, the contest was between the wronged trust beneficiaries whose property had been taken and Graphicshoppe's unsecured creditors. Per Lax J., "[i]t would be unjust and inequitable to apply the [lowest intermediate balance] rule in these circumstances to deprive the [beneficiaries] of their own property and correspondingly benefit the creditors of the bankrupt's estate at their expense."[41] Therefore, the beneficiaries were entitled to payment of their claims in full out of the money in the account.

3. Discussion

Lax J. took an expansive view of what the *LSUC* case decided, claiming that the case "represents a shift in the determination of the

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37 *Graphicshoppe* CA, *supra* note 9 at paras 3-7.

38 RSO 1990, c P.8, s 57.

39 *Graphicshoppe* CA, *supra* note 9 at paras 8-13.

40 *Supra* note 8 at para 34. The quoted words originate in the *LSUC* case (*supra* note 3 at para 31).

41 *Graphicshoppe* Sup Ct, *supra* note 8 at para 34.

proprietary interest of injured beneficiaries and a recognition that the [lowest intermediate balance rule is a legal fiction] and can work manifest unfairness."[42] Specifically, she read the *LSUC* case as abolishing the lowest intermediate balance rule and giving the courts *carte blanche* to allocate the disputed funds in any manner they see fit. The basis for her approach was the statement in the *LSUC* case that the court should "seek to apply the method which is the more just, convenient and equitable in the circumstances."[43] But Lax J. quoted this statement out of context. The statement appears at the end of a paragraph where Blair J. discusses "two general approaches" which may be taken in resolving disputes of this kind, namely the lowest intermediate balance rule and the *pro rata* sharing approach.[44] It is clear, therefore, that the statement supports the availability of a choice between these two methods, but not a discretion at large.

It follows that, even if Lax J. was right in assuming that the *LSUC* case was relevant to the dispute before her, she still would not have been justified in giving the employees first claim on the funds. Proper adherence to the *LSUC* case would have required a *pro rata* sharing of the funds between the employees and the estate. But it is open to question whether the *LSUC* case was relevant at all. Ostensibly, at any rate, the case only applies to beneficiary-beneficiary disputes or, in other words, to cases where the contest is between innocent victims and in victim-wrongdoer disputes, where the lowest intermediate balance rule continues to apply. Lax J. notes in her judgment that the dispute before her was "between wronged trust beneficiaries, whose property was taken, and creditors of the bankrupt."[45] She might have gone on to say that the *LSUC* case was applicable on the basis that the beneficiaries and the creditors were all innocent victims and that, therefore, the *pro rata* sharing rule applied. But, as already indicated, she did not take this tack. In any event, she would have been wrong to do so. The dispute in *Graphicshoppe* was between the employee beneficiaries and the wrongdoer's trustee in bankruptcy (not the creditors). It is true that a trustee in bankruptcy represents the creditors' interests, but the trustee also stands in the debtor's shoes and, in that capacity, the trustee inherits no larger rights than those previously held by the debtor itself.[46] This means that the trustee's entitlements relative to those of competing claimants can be no larger than the debtor's relative entitlements. Otherwise, parties may use the bankruptcy system opportunistically, as a means of changing the

42 *Ibid* at para 30.
43 *LSUC*, *supra* note 3 at para 31.
44 *Ibid*.
45 *Graphicshoppe* Sup Ct, *supra* note 8 at para 34.
46 *BIA*, *supra* note 20, s 71.

relative entitlements in their favour. This is basic bankruptcy policy.[47] It follows that *Graphicshoppe* was a beneficiary-trustee (wrongdoer) case, not a dispute between innocent victims, and so the *LSUC* case was distinguishable.[48]

Lax J.'s decision rests on the assumption that the closing balance was, as to $93,000, the beneficiaries' "own property." But this characterization is inconsistent with the property-based theory of tracing, to which she makes no reference. Furthermore, she fails to explain why, given that the contest was between the employee beneficiaries and Graphicshoppe's creditors, rather than Graphicshoppe itself, considerations of justice and equity should favour one group of innocent claimants over another. When the case went on appeal, Justice Juriansz suggested that "creditors should not expect to benefit from their borrowers' dishonest dealings with trust beneficiaries."[49] But this is simply question-begging. In summary, the employee-beneficiaries may have been more deserving than the unsecured creditors, but Lax J. (and Juriansz J.A.) had no way of knowing this and the decision to favour the employee-beneficiaries was blatantly result-driven.

4. The Appeal

Lax J.'s decision was overturned on appeal (Justices Moldaver and Armstrong, with Juriansz J.A. dissenting). Moldaver J.A. (as he then was), for the majority, recognized the point made above, namely that a dispute between a wrongdoer's trustee in bankruptcy and a victim of the wrongdoing should be treated on the same footing as a wrongdoer-victim (trustee-beneficiary) case, rather than as a contest between two groups of innocent victims. On that basis, he held that the *LSUC* case had no application:

> In *LSUC*, all of the funds in issue were trust funds. Even though the defalcating lawyer had made an assignment into bankruptcy, there was no issue about whether the funds in question formed part of the estate divisible among his creditors; they did not. Rather, in *LSUC*, the court was solely concerned with how best to allocate the funds

47 See generally Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Boston: Harvard University Press, 1986).

48 Compare *Port Alice Specialty Cellulose Inc. (Trustee of) v ConocoPhillips Co.*, 2005 BCCA 299, 254 DLR (4th) 397. There the court overlooked the point made in the text and applied the *pro rata* sharing rule in a bankruptcy context (Duggan, *supra* note 14 at 299-300).

49 *Graphicshoppe* CA, *supra* note 9 at para 111.

> remaining in the mixed trust account between competing beneficiaries.[50]

The "reasons in support of the *pari passu ex post facto* approach have no application in a case where the concern is not how to allocate the shortfall of funds remaining in a mixed trust account…but is rather how to determine if funds in the hands of a bankrupt at the date of bankruptcy are actually, in whole or in part, trust funds," and so not property divisible among creditors in bankruptcy.[51]

The *LSUC* case and *Graphicshoppe* CA, in combination, appeared to have created a distinction between beneficiary-beneficiary cases and trustee-beneficiary cases, with the *LSUC* case holding that the lowest intermediate balance rule does not apply to beneficiary-beneficiary disputes and *Graphicshoppe* holding that it does apply to trustee-beneficiary disputes. But the distinction does not hold up. In *Graphicshoppe* CA, Moldaver J.A. made the following observation about Blair J.'s reasoning in the *LSUC* case:

> [The reasoning] ought not to apply here, because I cannot accept that at the date of bankruptcy, the bankrupt's bank account in this case was, in fact, a "mixed" fund. Since it is clear on the evidence that the [trust monies] were totally dissipated *before* the monies from Textron were deposited into the bankrupt's bank account, as a matter of fact there is no mixture here.[52]

This statement is entirely consistent with the analysis of Example 2, above, where the deposit which replenished the account was T's own money. But it is also consistent with the analysis of Example 4, where the deposit which replenished the account was money belonging to another beneficiary. In summary, the policy considerations Moldaver J.A. relies on to support application of the lowest intermediate balance rule in a case like Example 2 apply equally in a case like Example 4. There is no principled basis for applying the rule in one case, but not the other.

C. *BOUGHNER*

1. The Facts

The case involved a fraudulent investment scheme. Investors were induced to place money with the Greyhawk Fund by misrepresentations that it was a large and profitable investment vehicle. During the

50 *Ibid* at para 125.
51 *Ibid* at para 128.
52 *Ibid* at para 129 [emphasis in original].

period of the fraud, the funds of twenty-four investors were commingled in a number of trading accounts. A receiver was appointed following discovery of the fraud and there turned out to be a substantial shortfall in the accounts. There was disagreement among the investors as to how the remaining funds should be distributed. One group of investors argued for a *pro rata* distribution based on original contributions to the fund. Another group supported application of the lowest intermediate balance rule. The receiver sought directions on how to make the distribution. The receiver testified that the calculations required by the lowest intermediate balance rule could be made.[53]

2. The Decision

Greymac was cited as authority for the proposition that in a beneficiary-beneficiary dispute, the courts should apply a *pro rata* sharing rule. But as Morawetz J. pointed out, there are two versions of the *pro rata* sharing rule, one which incorporates the lowest intermediate balance rule and the other which does not. The former is sometimes referred to as "*pro rata* on the basis of tracing,"[54] while the latter is known as the "*pro rata* method" or the "*pro rata ex post facto* method."[55] Under the *pro rata ex post facto* approach, the disputed funds are distributed *pro rata* based on each claimant's original contribution to the fund. Under the *pro rata* on the basis of tracing approach, the funds are distributed *pro rata* based on the value of the contributions at the time the funds are commingled.[56]

Morawetz J. used the following example to explain the difference: "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."[57] If the lowest intermediate balance rule applies, the analysis is as follows:

> 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.

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53 *Boughner*, *supra* note 10 at paras 8-20.
54 *Ibid* at para 3.
55 *Ibid* at para 2.
56 *Ibid* at para 37.
57 *Ibid* at para 4.

> Therefore, of the $120 remaining in the fund, A can claim $40 while B can claim $80.[58]

On the other hand, if the *pro rata ex post facto* approach is applied, "both A and B would receive $60, since both invested an equal amount: $100."[59]

In the *LSUC* case, Blair J. overlooked this distinction and he read *Greymac* as supporting a *pro rata* sharing approach in preference to the lowest intermediate balance rule. But as Morawetz J. makes clear in *Boughner*, the two approaches are not mutually exclusive and a careful reading of *Greymac* indicates that the case supports the *pro rata* on the basis of tracing approach. This is not immediately apparent because the Court's main focus in *Greymac* was on whether the rule in *Clayton's Case* should apply in beneficiary-beneficiary disputes. As indicated earlier, the Court rejected this approach in favour of a *pro rata* sharing rule but, in doing so, it made only passing references to the lowest intermediate balance rule. Nevertheless, Morawetz J. was able to find sufficient clues in the judgment to indicate that when the Court referred to *pro rata* sharing, it had in mind *pro rata* sharing on the basis of tracing. In summary, contrary to what was said in the *LSUC* case, *Greymac* supports application of the lowest intermediate balance rule in beneficiary-beneficiary disputes. This is subject to the qualification that if the calculations required by the lowest intermediate balance rule in a particular case would be too difficult, the court may revert to the *pro rata ex post facto* method. But in the present case, the receiver had clearly testified that the calculations were not a problem and so the qualification did not apply. Morawetz J. distinguished the *LSUC* case on this basis. He also pointed out that the Ontario Court of Appeal's decision in *Greymac* was confirmed by the Supreme Court of Canada and so it was the superior authority.[60] Therefore, to the extent of any inconsistency between the *LSUC* case and *Greymac*, *Greymac* must prevail. As mentioned earlier, Morawetz J.'s analysis was approved by the Ontario Court of Appeal.[61]

3. Discussion

Boughner removes any residual uncertainty there may have been, following the Ontario Court of Appeal's decision in *Graphicshoppe*, as to the application of the lowest intermediate balance rule. In particular, in the wake of *Graphicshoppe*, it appeared that the lowest

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58 *Ibid* at para 5

59 *Ibid* at para 6.

60 *Ibid* at para 88.

61 See *supra* note 10 and accompanying text. The decision was also recently followed by the Alberta Court of Appeal in *Wiseman* (*supra* note 18).

intermediate balance rule might or might not apply, depending on whether the case involved a trustee-beneficiary dispute or a beneficiary-beneficiary dispute. *Boughner* abolishes this distinction and, in so doing, it brings Canadian law back into line with the law in other parts of the Commonwealth.[62] In other words, Canadian law has come full circle after a fifteen year detour and some protracted litigation. The one remaining fly in the ointment is the suggestion in *Boughner*, picking up on *Greymac*, that a court may decline to apply the lowest intermediate balance rule in a particular case, and revert to the *pro rata ex post facto* rule instead, if it finds that, having regard to the number of beneficiaries or the number and frequency of movements in the disputed account, the calculations required by the lowest intermediate balance rule would be too complex. It would be easy enough to invoke this qualification if, as in *Graphicshoppe*, the court does not like the outcome the lowest intermediate balance rule dictates and is anxious to avoid it. In summary, the courts should rely on the qualification sparingly and resist the temptation to use it as a vehicle for achieving result-based solutions.[63] The implications of the Ontario cases in the PPSA context are discussed in Part IV, below. In the PPSA context, it can be predicted that the courts will have less occasion to use the qualification as a reason for not applying the lowest intermediate balance rule. While in the trusts context, cases involving numerous competing beneficiaries may be quite common, the same is not true in the PPSA context. In the PPSA context, the dispute is between secured parties, not trust beneficiaries, and typically there will be just two, or perhaps three, parties laying claim to the bank account.

IV. SOME PPSA IMPLICATIONS

Example 7

> SP holds a perfected security interest in D's pickup truck. On Date 1, D sells the truck for $1,000 without SP's authority and deposits the money in D's personal bank account. On Date 2, D deposits $500 of D's own money. On Date 3, D withdraws $800, leaving $700 in the account. On Date 4, D deposits $300, again his D's money, taking the account balance up to $1,000. On Date 5, SP discovers D's

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62 For a concise statement of the law in other parts of the Commonwealth, see Calnan, *supra* note 21 at paras 8.193-8.207.

63 So far the signs seem promising. For example, in E*asy Loan Corp. v. Base Mortgage & Investments Ltd.* (2016 ABQB 77, 613 AR 384), the Court opted to apply the lowest intermediate balance rule (an appeal against this decision was dismissed in *Wiseman*, *supra* note 18), while in *Bonnie Cummings v. Peopledge HR Services Inc.* (2013 ONSC 2781), the Court opted for *pro rata* sharing, but its reasons for rejecting the lowest intermediate balance rule appear sound (*ibid* at para 29).

wrongdoing. On Date 6, D becomes bankrupt. There are no further movements in the account after Date 4.

Example 7 is an adaptation of Example 2 to the PPSA context. In the immediate aftermath of the *LSUC* case, it may have been uncertain whether the lowest intermediate balance rule applied. Example 7 involves a victim (SP)-wrongdoer (D) dispute and, on a narrow reading, the *LSUC* case is relevant only to victim (beneficiary)-victim (beneficiary) disputes. But, as indicated earlier, the *LSUC* case could be read more broadly as suggesting that the lowest intermediate balance rule does not apply in either case. *Graphicshoppe* dispels that suggestion, with the result that there is now no doubt the rule does apply in cases like Example 7. Therefore, SP's claim on the account is limited to $700, with the balance of the funds going to D's trustee in bankruptcy.

In Example 7, it is appropriate to characterize SP and D as "victim" and "wrongdoer," respectively, because D sold the truck and banked the sale proceeds without SP's consent. In this respect, the case is on all fours with Example 2. But suppose, instead, that SP authorized the sale and D's banking of the sale proceeds. SP still has a claim to the proceeds,[64] but on these new facts D's conduct is not unlawful. The rule in *Re Hallett's Estate* was framed with the case of a dishonest trustee in mind, but it seems to be generally accepted that the rule should be extended to cases where the defendant acted lawfully in depositing the disputed funds.[65] On this basis, the analysis of Example 7 is the same, whether or not SP authorized the sale and the deposit.

In Example 7, SP's security interest was perfected at the date of D's bankruptcy. The outcome of the case would be different otherwise. The PPSAs provide that an unperfected security interest is ineffective against the debtor's trustee in bankruptcy.[66] This provision displaces the tracing rules with the result that if SP's security interest is unperfected, its claim is defeated and the whole of the closing account balance goes to the estate.

Example 8

SP1 holds a perfected security interest in D's pickup truck. On Date 1, D sells the truck for $1,000 and deposits the money in D's personal bank account. SP2 holds a perfected security interest in D's trailer. On Date 2, D sells the trailer

64 See e.g. Saskatchewan *PPSA*, *supra* note 12, s 28(1).

65 Lionel D Smith, *The Law of Tracing* (Oxford: Clarendon Press, 1997) at 208-212; Ronald CC Cuming, Catherine Walsh & Roderick J Wood, *Personal Property Security Law*, 2nd ed (Toronto: Irwin Law, 2012) at 569.

66 See e.g. Saskatchewan *PPSA*, *supra* note 12, s 20(2)(a).

> for $500 and deposits the money in the same account. On Date 3, D withdraws $800, leaving $700 in the account. On Date 4, SP1 and SP2 learn about these events. On Date 5, D becomes bankrupt. There are no further movements in the account after Date 3.

Example 8 is an adaptation of Example 3 to the PPSA context. The case involves a victim (SP1)-victim (SP2) dispute. *Greymac* clearly establishes that, in such cases, as a general rule, the disputed funds should be distributed *pro rata* between SP1 and SP2 in proportion to their contributions. On this basis, SP1 and SP2 share the $700 closing balance in the proportions 2:1. The PPSA priority rules make no difference to this outcome because SP1 and SP2's claims are to different parts of the fund. This point can be seen clearly by recalling that SP1's claim on the fund relates to proceeds of the truck, whereas SP2's claim on the fund relates to proceeds of the trailer; if D had not converted the truck and the trailer, SP1's claim would have been to the truck and SP2's claim would have been to the trailer. Since the claims are to different collateral, they are not in conflict and so the PPSA priority rules are not engaged. The same point flows through to the proceeds claims.

Example 9

> SP1 holds a perfected security interest in D's pickup truck. On Date 1, D sells the truck for $1,000 and deposits the money in D's personal bank account. On Date 2, D withdraws $800, leaving $200 in the account. SP2 holds a perfected security interest in D's trailer. On Date 3, D sells the trailer for $500 and deposits the money in the same account, taking the balance up to $700. On Date 4, SP1 and SP2 learn about these events. On Date 5, D becomes bankrupt. There are no further movements in the account after Date 3.

Example 9 is Example 4 adapted to the PPSA context. The case involves a victim (SP1)-victim (SP2) dispute. In the wake of the *LSUC* case, it might be thought that SP1 and SP2 should share the $700 *pro rata* in proportion to their original contributions. But *Boughner* dispels this suggestion. The applicable rule is not *pro rata ex post facto* but, rather, *pro rata* sharing on the basis of tracing. SP1's claim on the account drops to $200, following D's Date 2 withdrawal. Therefore, SP1's contribution to the fund is $200 while SP2's is $500 and they share the remaining $700 in those proportions.[67]

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67 See Cuming, Walsh & Wood, *supra* note 65 at 572-73 (written before *Boughner*, but taking a view that is consistent with what is said in the text, above).

Example 10

> SP1 holds a perfected security interest in D's pickup truck. On Date 1, D sells the truck for $1,000 and deposits the money in D's personal bank account. SP2 holds a perfected security interest in D's trailer. On Date 2, D sells the trailer for $500 and deposits the money in the same account. On Date 3, D withdraws $800, leaving $700 in the account. On Date 4, D deposits $300 of his own money, taking the account balance up to $1,000. On Date 5, SP1 and SP2 learn about these events. On Date 6, D becomes bankrupt. There are no further movements in the account after Date 4.

Example 10 is Example 5 adapted to the PPSA context. The case involves both victim (SP1)-victim (SP2) and victim (SP1/SP2)-wrongdoer (D) disputes. In the aftermath of *Graphicshoppe*, the lowest intermediate balance rule applies, with the result that SP1's and SP2's combined claims on the funds are limited to $700. They share this amount *pro rata* in proportion to their contributions (2:1) and the $300 balance goes to the estate.

Example 11

> SP1 holds a perfected security interest in D's pickup truck. On Date 1, D sells the truck for $1,000 and deposits the money in D's personal bank account. SP2 holds a perfected security interest in D's trailer. On Date 2, D sells the trailer for $500 and deposits the money in the same account. On Date 3, D deposits $200 of D's own money. On Date 4, D withdraws $1,000, leaving $700 in the account. On Date 5, SP1 and SP2 learn about these events. On Date 6, D becomes bankrupt. There are no further movements in the account after Date 4.

Example 11 is Example 6 adapted to the PPSA context. Again, the case involves both victim-victim and victim-wrongdoer disputes. But this time, the rule in *Re Hallett's Estate* applies to determine the victim-wrongdoer part of the contest. D's Date 4 withdrawal is debited against D's own contribution to the account (the $200 Date 3 deposit), eliminating D's stake in the account. The result is that D's trustee has no claim on the $700 closing balance and SP1 and SP2 share these funds *pro rata* in proportion to their contributions (2:1).

Example 12

> SP1 holds a perfected security interest in all D's present and after-acquired personal property. D's assets include a pickup truck. On Date 1, D sells the truck for $1,000 and

> deposits the money in his personal bank account. SP2 has a perfected security interest in D's trailer. On Date 2, D sells the trailer for $500 and deposits the money in the same account. On Date 3, D deposits $200 of D's own money. On Date 4, D withdraws $1,000, leaving $700 in the account. On Date 5, SP1 and SP2 find out about these events. On Date 6, D becomes bankrupt. There are no further movements in the account after Date 4.

Example 12 is like Example 11, except that now SP1's security interest is in all D's personal property, not just the pickup truck. Given this, SP1 has a claim on the entire closing account balance ($700) as original collateral. SP2 has a proceeds claim on the account for an amount in proportion to its share of the fund on the date of the commingling (Date 2). At Date 2, SP1's and SP2's contributions were valued at $1,000 and $500 respectively, and so SP2's proceeds claim is for one third of the closing balance ($233.33). SP1 and SP2 are in competition to the extent of SP2's entitlement and the PPSA applies to determine the priorities. The result is that $233.33 is payable out of the closing balance to either SP1 or SP2, depending on the PPSA priorities, while the remainder is payable to SP1 as part of its original collateral.[68] As in Example 11, D's trustee has no claim.

Changing the facts of Example 12 slightly, assume that on Date 4, D deposits $300 of D's own money, taking the account balance up to $1,000. All other facts stay the same. Applying the lowest intermediate balance rule, SP2 has no claim to the $300 Date 4 deposit and so its entitlement remains unchanged. But SP1 does have a claim to the Date 4 deposit as part of its original collateral. In summary, the effect of the Date 4 deposit is to increase the amount of SP1's entitlement, but it does not improve SP2's position.

V. CONCLUSION

The uninitiated may think of the PPSA as an impenetrable statute with an arcane and technical subject-matter. To those in the know, however, secured transactions law is an alluring subject not only because a close reading of the statute reveals its subtleties, but also because secured transactions law interacts, in fascinating ways, with just about every aspect of private law. Some of the more obvious examples include property and contract law, the law of negotiable instruments, sales law and, of course, as this paper demonstrates, equity and trusts. This means that one cannot aspire to PPSA expertise without also having a sound grasp of private law across

68 My thanks to Tamara Buckwold for her contribution to this analysis.

the board. In other words, it takes a good commercial lawyer to make a good PPSA scholar. This point was brought home to me most forcefully, when I first came to the PPSA through my early conversations with Professor Cuming and through reading his prodigious body of PPSA scholarship. A significant part of the explanation for Professor Cuming's world-wide reputation as a PPSA scholar, teacher and law reformer is that he happens to be an outstanding commercial lawyer in general. The topic of this paper was chosen to illustrate these points, to celebrate the breadth of Professor Cuming's scholarship, and in gratitude for all I have learned from him.