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Recommended Citation

Dale A. Oesterle, *Deficiencies of the Restitutionary Right to Trace Miappropriated Property in Equity and in UCC 9-306*, 68 Cornell L. Rev. 172 (1983)

Available at: <http://scholarship.law.cornell.edu/clr/vol68/iss2/4>

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Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306

Dale A. Oesterle†

INTRODUCTION

The restitutionary right to trace misappropriated property into its product is a powerful and pervasive remedial right.¹ Tracing relief can augment normal measures of recovery significantly whenever a claimant can identify specific property held by a defendant as derivative of property against which the claimant had or has an *in specie* claim. The *in specie* claim can originate in rights born in the various substantive fields of private law—tort, contract, fraud, restitution, commercial law, and creditor's rights. The primary aims of this article are to identify deficiencies in the case law defining the right to trace and to offer suggestions for correcting these deficiencies. Because tracing has wide application as a remedial theory, the analysis in this article has implications for many areas of the law. The article develops these implications in tracing's traditional settings. Where tracing has been incorporated into sophisticated statutory schemes, such as Article Nine of the Uniform Commercial Code, however, the article exposes the deficiencies and, with tentative suggestions, invites veterans of these statutory domains to address the problems.

I

TRACING DEFINED

An analysis of tracing must begin with a definition of the right. Despite the straightforward appearance of its name, restitutionary

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¹ The primary American reference works on tracing are RESTATEMENT OF RESTITUTION §§ 202-215 (1936); D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 421-30 (1973); 1 G. PALMER, THE LAW OF RESTITUTION §§ 2.14-2.19 (1978); 5 A. SCOTT, THE LAW OF TRUSTS §§ 507-522 (3d ed. 1967). Important early articles on the topic are Ames, *Following Misappropriated Property Into Its Product*, 19 HARV. L. REV. 511 (1906); Williston, *The Right to Follow Trust Property When Confused With Other Property*, 2 HARV. L. REV. 28 (1888). English law on tracing is ably discussed in R. GOFF & G. JONES, THE LAW OF RESTITUTION 46-63 (2d ed. 1978).

“tracing” is not a simple concept, and Anglo-American lawyers have used it to describe a variety of claims. For the purposes of this article, I define tracing as a restitutionary right to claim specific property, not otherwise subject to a possessory or ownership interest of the claimant, that arises from a property interest of the claimant in other property that another has misappropriated. Thus, the claim has two basic elements. First, it is asserted against specific property in which the claimant himself has no property interest other than that which the right provides. Second, the property claimed is identifiably linked in select ways to a misappropriated property interest. The following hypothetical illustrates the concept in its most elemental form:

Owner has legal title to a motor vehicle. Defendant misappropriates the vehicle and exchanges it for stock from a third party. Owner can “trace” into the stock and demand it *in specie*.

Observe that in satisfaction of the first element the Owner’s claim is respected even though he had no pre-existing property interest in the stock; the stock is a substitute for the misappropriated motor vehicle. Note also that an owner who claims superior title to the vehicle over the third party as the result of a pre-existing interest does not, according to my definition, assert a tracing claim. Some would disagree, however, and say that the owner “traces” his property through the exchange into the hands of the third party, especially when the third party is a bankruptcy trustee or the like.²

The second element, the requirement of an identifiable link between the substitute property against which the tracing claim is made and the misappropriated property, is satisfied by one or more of three events. The defendant can acquire the substitute property: (1) in a direct exchange for the misappropriated property;³ (2) as income (rent, interest, royalties, crops, or profit) produced by the misappropriated property;⁴ or (3) as part of an identifiable fund of money in which mis-

² See, e.g., *Surgi v. First Nat’l Bank & Trust Co.*, 125 F.2d 425, 429 (5th Cir. 1942); *Otis v. Otis*, 167 Mass. 245, 246, 45 N.E. 737, 737 (1897). Consistent with my definition, tracing claims can be said to apply against third parties, if at all, only when the third party has received income from, exchanged something for, or commingled the misappropriated asset. See *infra* notes 23, 39.

³ See, e.g., *Haskel Eng’g & Supply Co. v. Hartford Accident & Indem. Co.*, 78 Cal. App. 3d 371, 144 Cal. Rptr. 289 (1978); *Middlebrooks v. Lonas*, 246 Ga. 720, 272 S.E.2d 687 (1980); *Lane County Escrow Serv., Inc. v. Smith*, 277 Or. 273, 560 P.2d 608 (1977). A version of the direct-exchange link occurs when the wrongdoer uses the property of the victim to discharge an obligation of the wrongdoer to a third person or to discharge a lien held by a third person upon the wrongdoer’s property. Such an exchange entitles the victim to be subrogated to the third person’s rights that were discharged by the payment. RESTATEMENT OF RESTITUTION § 207 (1936).

⁴ See, e.g., *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Peine v. Murphy*, 26 Hawaii 233, 377 P.2d 708 (1962); *McGaffee v. McGaffee*, 244 Iowa 879, 58 N.W.2d 357 (1953). In this setting, tracing merges into equitable accounting. Indeed, some commentators consider parts of equitable accounting to be an embodiment

appropriated money and other indistinguishable monies have been commingled.⁵ For simplicity sake I term them (1) "exchange tracing," (2) "income tracing," and (3) "commingled fund tracing." The plaintiff bears the burden of proving any transactional link between the misappropriated property and the property found in the defendant's hands.⁶

of the tracing doctrine. *E.g.*, D. DOBBS, *supra* note 1, at 253 ("The principle of tracing used in constructive trust cases is the same principle applied here, so that it is possible to think of the accounting for profits in [cases against nonfiduciaries] as simply a special form of constructive trust."). Equitable accounting provides a remedy very similar to the tracing remedy in cases of fiduciary breach, unfair competition, trademark infringement, or copyright infringement. *See, e.g.*, *Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.*, 240 U.S. 251 (1916) (accounting granted for profits received from use of plaintiff's trademark on defendant's shoes); RESTATEMENT OF RESTITUTION § 136 comment a (1936). The difficulty of crediting the defendant for expenses incurred in acquiring the profit and of apportioning the profit between the defendant's wrongful acts and his legitimate contributions poses questions that also arise in the context of tracing. *See infra* notes 54-58 and accompanying text. One commentator notes that "[i]t is enough to make anyone wonder whether the whole thing is worth it." D. DOBBS, *supra* note 1, at 277. The basic difference between a decree of accounting, and a decree for a constructive trust or equitable lien as a result of tracing, is that an accounting may result in a general money judgment, but a constructive trust or equitable lien must rest on the plaintiff's equitable ownership rights in specific property. Thus, if an accounting is proper, the defendant is liable for even those profits that he has dissipated; the plaintiff obtains a money judgment that the defendant must satisfy from his other assets. For a constructive trust decree to be proper, however, the plaintiff must identify in the defendant's hands the profits received as a result of the wrong. *See* RESTATEMENT OF RESTITUTION §§ 198, 215 (1936).

⁵ If the plaintiff's property is mixed with other indistinguishable property, as is usually the case when money is converted, Anglo-American courts allow the plaintiff to claim a specific proportion of the mixed pool of assets. The *Restatement*, for example, applies commingling rules to money and cases in which "the wrongdoer acquires property with money of another and money of his own, even though the money is not physically mingled." RESTATEMENT OF RESTITUTION § 210 comment a, § 214 (1936); *see also* *Montgomery v. United States Nat'l Bank*, 220 Or. 553, 349 P.2d 464 (1960) (commingling turkeys). The victim is said to "own" part of the commingled mass, even though he cannot identify specific property that originally was in his possession. *See, e.g.*, *Rackely v. Mathews*, 141 Fla. 307, 309, 193 So. 69, 70 (1940); *First Trust Co. v. Exchange Bank*, 126 Neb. 856, 870-72, 254 N.W. 569, 576 (1934). *But cf.* *Thomas v. Wasson*, 191 Ark. 869, 875-76, 88 S.W.2d 327, 330 (1935) (county treasurer who deposited public funds in bank such that bank became trustee is not entitled to preference over bank commission when bank failed). The victim's claim is superior to the claims of other creditors of the fund. It is unjust, many argue, for creditors to collect from an insolvent estate that the victim's misappropriated property or funds have specifically augmented. A creditor of the wrongdoer assumes the risk of his insolvency, but the victim, an involuntary creditor, does not. *See In re Kountze Bros.*, 79 F.2d 98, 102 (2d Cir.), *cert. denied*, 296 U.S. 640 (1935) ("[T]he fiduciary's creditors have accepted the risk of his solvency, while his cestuis have accepted only the risk of his honesty."); *see also* 1 G. PALMER, *supra* note 1, at 185.

Although early English courts were willing to grant relief in replevin for the "confusion" of fungible goods, *see* C. BROWN, *THE LAW OF PERSONAL PROPERTY* §§ 6.8-14 (3d ed. 1975), these courts held that any right to follow money mingled with money of another was lost because "money has no earmark." *See, e.g.*, *Whitecomb v. Jacob*, 1 Salk. 160, 91 Eng. Rep. 149 (Ch. 1710). Thus money could be traced only if kept separate and invested in other property. *See, e.g.*, *Ex parte Dale & Co.*, 11 Ch. D. 772, 775-76 (1879). In 1879, Jessel, M.R., believed the law inadequate and created the commingling branch of tracing in equity. *See* *Knatchbull v. Hallett*, 13 Ch. D. 696, 714 (1879). Some writers would extend the equitable doctrine to cases involving fungible goods, eclipsing the replevin remedy for confusion. *See* RESTATEMENT OF RESTITUTION § 214 (1936).

⁶ RESTATEMENT OF RESTITUTION § 215 comment b (1936). In commingled-fund

A causal but nontransactional link between a misappropriation and the ability of the wrongdoer to hold or acquire other property is not sufficient to support tracing into the other property. For example, imagine a thief who must spend \$100 on food to sustain himself, and who has \$100 in gold coins. Instead of spending the coins on food, he steals bearer bonds worth \$100 and exchanges them for food that he consumes. In this situation the victim cannot trace into the gold coins, even though the thief has retained the coins only because he stole the bonds.⁷

Tracing is a restitutionary right in two senses. First, although the claimant does not obtain restitution of his original property, he does receive a specific substitute therefor. Tracing thus appears to comport with an inexact but popular man-in-the-street understanding of the term "restitution." Second, and more significantly, theorists argue that tracing is restitutionary in that the doctrine is premised on the principle of unjust enrichment⁸—the conceptual thread that is said to unite all

cases, however, once the plaintiff proves that the defendant possesses the fund, some jurisdictions shift the burden of proof on apportionment to the defendant. *E.g.*, *Hurst v. Hurst*, 1 Ariz. App. 603, 405 P.2d 913 (1965); *Winger v. Chicago City Bank & Trust Co.*, 394 Ill. 94, 67 N.E.2d 265 (1946). *But see* *Simonson v. McInville*, 42 Wis. 2d 346, 166 N.W.2d 155 (1969) (burden of identification of portion of fund is on plaintiff).

⁷ The RESTATEMENT OF RESTITUTION § 215 comment a (1936) contains the following example:

[Tracing is inapplicable] although it is proved that if the wrongdoer had not dissipated the property of the claimant he would have dissipated other property which he still holds. Thus, if a person wrongfully takes money belonging to another person and uses the money in paying an unsecured debt of the wrongdoer and the creditor has no notice of the wrong, the other person is not entitled to priority over the general creditors of the wrongdoer, even though it is proved that if the wrongdoer had not succeeded in getting the money of the other person he would have sold certain securities of his own and used the proceeds in paying the debt. In such a case the wrongdoer does not hold the securities or any of his other property upon a constructive trust for or subject to an equitable lien in favor of the person whose money he wrongfully used.

⁸ The principle of unjust enrichment has two primary elements. First, the defendant must receive a benefit. Second, the defendant's retention of the benefit must be unfair or unjust. Some writers break the second element down into two separate considerations: (a) the defendant's enrichment is at the plaintiff's expense; and (b) to allow the defendant to retain the benefit would be unjust. *See, e.g.*, *R. GOFF & G. JONES, supra* note 1, at 11-25. Professor Dawson argues that because restitution does not usually depend on a showing that someone's aggregate wealth has increased, the word "enriched" should be abandoned in favor of a more "neutral" phrase, such as "the retrieval of unjustified acquisition." Dawson, *Restitution Without Enrichment*, 61 B.U.L. REV. 563, 577 (1981).

The second element—unjustness—may be satisfied by the defendant's violation of duties defined by the law of torts, contracts, or fiduciary duties. In these cases, restitution provides alternative remedies. The elements also may be satisfied by the presence of circumstances prescribed solely through the evolution of the restitutionary doctrine itself. In these cases, restitution provides the only remedy. The latter category is illustrated by the restitutionary rule that forces the defendant to disgorge money received from the plaintiff as a result of the plaintiff's mistaken belief that the defendant is a creditor; no tort or contract doctrine will otherwise provide relief. *See* RESTATEMENT OF RESTITUTION § 126 comment b, illustration 1 (1936). The basis for calling the substantive rules in this latter category restitutionary is the theory of relief that accompanies the substantive right; courts award a judgment based on an

restitutionary doctrines.⁹ Tracing, many believe, is a part of restitution because it divests the wrongdoer of gains inappropriately obtained at the plaintiff's expense. For example, if a thief steals an asset with a market value of ten dollars, and is able to trade it for an asset worth twenty dollars, courts will not limit the victim to a remedy of ten dollars in damages. By allowing the victim to claim specifically the twenty-dollar asset, the courts force the thief to disgorge all of the benefits that he unjustly obtained from the theft. If the victim were limited to an ordinary damages remedy, the thief would "profit from his wrong," for he would retain a ten-dollar profit after paying the damages. In addition, the argument continues, allowing thieves to retain such profits would encourage future thefts. In sum, courts find it more desirable to give the victim a windfall of ten dollars than to allow the wrongdoer to keep any profit.

As is evident from the foregoing discussion, the basic tracing paradigm has substantial intuitive appeal. Notions of vindicating title, of

assessment of the defendant's gain rather than the plaintiff's loss. The first element, therefore—the defendant's inappropriate receipt of a benefit—and not the characterization of the defendant's wrongful act, gives restitution a distinctive flavor. Restitution focuses not on compensating the plaintiff for his losses as is common in tort and contract law, but on the unfairly enhanced position of the defendant, and operates to strip him of his benefit. This approach characterizes restitution both when it provides alternative relief for wrongs defined by other fields of the private law, and when it operates on its own. See RESTATEMENT OF RESTITUTION § 202 comment c (1936); 1 G. PALMER, *supra* note 1, § 2.10, at 133 ("Restitution is generally awarded only in order to deprive the defendant of an enrichment obtained at the plaintiff's expense. . . .").

⁹ The precise boundaries of this branch of law are not well defined. Although many writers exclude common law actions of trover, trespass to chattels, trespass for mesne profits, detinue, replevin, and ejectment, *see, e.g.*, RESTATEMENT OF RESTITUTION Introductory Note to ch. 7 (1936), these actions may provide a form of relief very similar to the more traditional restitutionary doctrines. *See* Oesterle, *Book Review*, 79 MICH. L. REV. 336, 338-39 (1980). The literature is ambivalent on whether to define the field through the principle of unjust enrichment or by reference to a few select historic doctrines. *See id.* Restitution is most commonly understood, however, as a grab bag of judge-made rules developed originally in both the early Anglo-American law and equity courts. *See* Dawson, *supra* note 8, at 564. The law courts created the common counts in general *assumpsit*, known by their specific names of "work and labor done" (*quantum meruit*), "money had and received," "goods sold and delivered" (*quantum valebant*), and "money lent." The equity courts developed the doctrines of specific restitution, constructive trust, equitable accounting, contribution, and indemnity. *See generally* 1 G. PALMER, *supra* note 1, §§ 1.2, 1.5. Many of these doctrines began as fictional outgrowths of established bodies of law; the common counts began as fictional contracts, and the constructive trust began as a fictional trust. As far back as 1888, commentators sought to unify the application of these ancient doctrines under the mantle of unjust enrichment, *see, e.g.*, Ames, *The History of Assumpsit*, 2 HARV. L. REV. 53, 64 (1888), and in 1936 the Restatement of Restitution recognized and legitimized the new field.

English courts have not yet explicitly recognized any generalized right to restitution in cases of unjust enrichment. *See, e.g.*, *Orakpo v. Manson Invs. Ltd.*, 1978 A.C. 95, 104. Their reluctance is grounded in the fear that the principle of unjust enrichment is too vague to be of practical value as a legal rule. *See, e.g.*, *Baylis v. Bishop of London*, 1 Ch. 127, 140 (1913) ("To ask what course would be *ex aequo et bono* to both sides never was a very precise guide. . . ."); *see also* Abbot, *Keener on Quasi-Contracts—I*, 10 HARV. L. REV. 209, 226 (1896). *But see* Hand, *Restitution or Unjust Enrichment*, 11 HARV. L. REV. 249 (1897).

detering misappropriation, of disgorging unlawfully acquired profits, and even in the very simple case of measuring accurately the victims true loss all seem to coalesce in support of the result. The tinsel attractiveness of the paradigm no doubt contributes to the expansiveness of tracing doctrines in current jurisprudence.

Even cursory attention to the defining concepts reveals the power and wide-ranging application of tracing doctrine. The claimant's original property interest—which forms the basis of a right to trace into substitute property—can be equitable as well as legal and includes, for example, a creditor's security interest in a debtor's property. Indeed, tracing originated as a device enabling beneficiaries of trusts to assert claims to specific property that trustees had realized privately from private dealings with the trust res.¹⁰ The property interest misappropriated may be in virtually any kind of identifiable property: land, money, bank accounts, tangible goods, stock, notes, or even an entry in a computer memory bank. In addition, the types of misappropriation that

¹⁰ The first appearance of the tracing remedy in Chancery decisions is hard to pinpoint. A scholar familiar with Chancery's earliest records (the Decree and Order Books kept about the time of Elizabeth I (1558-1603)) has stated:

[E]arly Chancery reports are so brief and uninformative that they disclose no real clues on the subject. . . . If trust assets were wrongfully used by the trustee himself for the acquisition of other assets, it seems unlikely that there would have been any scruple about ordering restoration of the newly acquired assets. . . .

J. DAWSON, *UNJUST ENRICHMENT* 26-27 (1951). After 1660, Chancery cases were regularly reported. J. BAKER, *AN INTRODUCTION TO ENGLISH LEGAL HISTORY* 94 (1979). The first recognizable claim for tracing relief appeared in *Kirk v. Webb*, Prec. Ch. 85, 24 Eng. Rep. 41 (1698). In *Kirk*, the trustee had converted a portion of the trust res into land and devised it. The beneficiary sued the devisees, asking for title to the land. The Chancellors denied the claim, reasoning that an award of the land to the beneficiary would contravene the recently enacted Statute of Frauds (1677).

The procedural history of *Kirk* reveals the status of tracing claims in 1698. Upon hearing the Master's report, the Lord Chancellor was initially of the opinion that "the lands might be followed." *Id.* at 87, 24 Eng. Rep. at 42. The defendants, arguing that "it was a matter of great consequence, and never done before," convinced the Lord Chancellor to include Justice Powell and the Master of the Rolls in the deliberations. *See id.* Eventually, the three Chancellors decided against the beneficiary and refused to give him title to the devised land. The Lord Chancellor and Justice Powell believed themselves bound by the Statute of Frauds. *See id.* The Master of the Rolls, however, noted, that "if it had been expressly and plainly proved that these purchases had been made with the profits of the trust estate, . . . it might have been otherwise." *Id.* Several cases followed *Kirk* in denying the relief. *E.g.*, *Cox v. Bateman*, 2 Ves. Sen. 19, 28 Eng. Rep. 13 (1715); *Hooper v. Eyles*, 2 Vern 480, 23 Eng. Rep. 908 (1704); *Heron v. Heron*, Prec. Ch. 163, 24 Eng. Rep. 78 (1701); *Newton v. Preston*, Prec. Ch. 103, 24 Eng. Rep. 50 (1699). This line of cases, however, was overruled 50 years later in *Lane v. Dighton*, Amb. 409, 27 Eng. Rep. 274 (1762) (citing *Ryall v. Ryall*, 1 Atk. 59, 26 Eng. Rep. 39 (1739)).

The first reported Chancery case in which a tracing argument appeared to succeed was *Burdett v. Willett*, 2 Vern. 638, 23 Eng. Rep. 1017 (1708), in which the Chancellors required a factor to remit to his principal the economic product of consigned goods. *See also* *Whitecomb v. Jacob*, 1 Salk. 160, 91 Eng. Rep. 149 (1710). *But see infra* note 31.

may give rise to tracing are highly varied: breach of trust¹¹ or fiduciary duty,¹² conversion,¹³ fraud,¹⁴ mistake,¹⁵ certain breaches of contract,¹⁶

¹¹ *Massachusetts Bonding & Ins. Co. v. Josselyn*, 224 Mich. 159, 162, 194 N.W. 548, 549 (1923) ("[W]here money held upon trust is misapplied by the trustee, and traced into an unauthorized investment in property of any nature, the investment thus made, . . . may be treated by the *cestui que trust* as made for his benefit."); *Erie Trust Co.'s Case* (No. 1), 326 Pa. 198, 191 A. 613 (1937). See generally RESTATEMENT (SECOND) OF TRUSTS § 202 (1959); G. BOGERT, THE LAW OF TRUST AND TRUSTEES §§ 921-30 (1978); 1 G. PALMER, *supra* note 1, §§ 2.14-.20; R. POWELL, REAL PROPERTY § 540 (1972); 5 A. SCOTT, *supra* note 1, §§ 508-522. The right occasionally is declared in statutes. See, e.g., CAL. CIV. CODE § 2243 (West 1954); GA. CODE ANN. §§ 108-424, 108-425 (1979); N.D. CENT. CODE § 59.01.06 (1960); S.D. CODIFIED LAWS ANN. § 55-1-9 (1980).

¹² In the late nineteenth century Anglo-American courts declared that tracing claims reach all fiduciaries who violate their duties. It is difficult to ascertain when this rule first appeared. The position was clearly stated in *In re Hallet's Estate*, 13 Ch. D. 696, 709, 710, 713-14 (1879), an opinion that cited *Whitecomb v. Jacob*, 1 Salk. 161, 91 Eng. Rep. 149 (1710) for support. The *Whitecomb* case, however, can be explained on other grounds. See *infra* note 31. Early American cases in accord with *Hallet's Estate* include *Humphreys v. Butler*, 51 Ark. 351 (1888); *National Mahaiwe Bank v. Barry*, 125 Mass. 20 (1878); *American Sugar Refining Co. v. Fancher*, 145 N.Y. 552 (1895).

A fiduciary can wrongfully appropriate a variety of interests and trigger tracing rights in the principal. For example, courts hold that an employee who receives trade secrets in confidence during the normal course of his employment, and uses the secrets himself, must account for all profits that he received from the improper use. See, e.g., *Telex Corp. v. International Business Machs. Corp.*, 510 F.2d 894 (10th Cir.), cert. dismissed, 423 U.S. 802 (1975); *Clark v. Bunker*, 453 F.2d 1006 (9th Cir. 1972); *International Indus. v. Warren Petroleum Co.*, 248 F.2d 696 (3d Cir. 1957); *Sandlin v. Johnson*, 141 F.2d 660 (8th Cir. 1944); *Hoeltke v. C.M. Kemp Co.*, 80 F.2d 912 (4th Cir. 1935), cert. denied, 298 U.S. 673 (1936). Similarly, if a fiduciary sells or otherwise profits personally from the use of confidential information, and the wronged beneficiary can identify the fund or property so acquired, the beneficiary may impose a constructive trust upon the fund or property. See RESTATEMENT OF RESTITUTION § 200 (1936). If a fiduciary diverts assets that he should have acquired on behalf of the beneficiary, the beneficiary may claim an equitable interest in the diverted assets, minus a credit for the personal funds used by the fiduciary in the purchase. See, e.g., *Wilson v. Jenning*, 344 Mass. 608, 619, 184 N.E.2d 642, 648 (1962); *Casari v. Victoria Amusement Enters., Inc.*, 327 Pa. 382, 388-89, 194 A. 503, 506-07 (1937). See generally RESTATEMENT OF RESTITUTION § 194 comment b (1936). A fiduciary who acquires an asset or profits through a business that competes with the business of the principal is said to hold the asset or profits in constructive trust for the principal. See, e.g., *Des Moines Terminal Co. v. Des Moines Union Ry.*, 52 F.2d 616 (8th Cir. 1931) (competing with beneficiary in business held violative of fiduciary duties in favor of beneficiary); see also *Sequoia Vacuum Sys. v. Stranksy*, 229 Cal. App. 2d 281, 40 Cal. Rptr. 203 (1964) (constructive trust the implicit remedy). The extreme case involves a principal claiming the profit acquired by a fiduciary when the principal never expected or intended the fiduciary to acquire the profit on the principal's behalf. E.g., *Diamond v. Oreamuno*, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969) (corporation claims profits received by officers and directors through inside trading).

¹³ *Newton v. Porter*, 69 N.Y. 133 (1877), extended the doctrine of constructive trust to all cases of conversion: "We are of opinion that the absence of the conventional relation of trustee and *cestui que trust* between the plaintiff and the [thieves], is no obstacle to giving the plaintiff the benefit of the notes and mortgage, or the proceeds in part of the stolen bonds." *Id.* at 140. American courts before *Newton* had consistently rejected the argument. See, e.g., *Pascoag Bank v. Hunt*, 3 Edw. Ch. 583 (N.Y. 1842). Some courts continued to resist after *Newton*, e.g., *Nert Bros. v. Dogge*, 27 Neb. 256, 42 N.W. 1035 (1889), but by the twentieth century the case was established doctrine. Justice Story was ahead of the times. In the 1834 and 1839 editions of his *Commentaries on Equity Jurisprudence*, he stated the position later taken by Judge Andrews in *Newton* as if it were already established law. 2 J. STORY, COMMENTA-

RIES ON EQUITY JURISPRUDENCE § 1258, at 503 (2d ed. 1839). After *Newton*, later editors of the Story treatise simply added a citation of the case to Story's early text. See, e.g., 3 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1666 n.5, at 306 (14th ed. 1918). English courts, however, have refused to follow *Newton* despite continuing criticism. See R. GOFF & G. JONES, *supra* note 1, at 53-60.

¹⁴ *Cunningham v. Pettigrew*, 169 F. 335, 340 (8th Cir. 1909); *Brennan v. Persselli*, 353 Ill. 630, 637, 187 N.E. 820, 822 (1933); *Falk v. Hoffman*, 233 N.Y. 199, 201, 135 N.E. 243, 244 (1922); *American Sugar Refining Co. v. Fancher*, 145 N.Y. 552, 561, 40 N.E. 206, 209 (1895).

¹⁵ *In re Berry*, 147 F.2d 208, 211 (2d Cir. 1906); *In re Woods*, 121 F. 599, 602 (D. Ga. 1903).

¹⁶ *Clark v. McCleery*, 115 Iowa 3, 87 N.W. 696 (1901) (subrogation); *Colby v. Street*, 146 Minn. 290, 178 N.W. 599 (1920) (specific restitution on traced property); *Mathews v. Crowder*, 111 Tenn. 737, 69 N.W. 779 (1902) (equitable lien on traced property). The facts in *Clark* aptly illustrate the potential range of *Newton v. Porter*, 69 N.Y. 133 (1877). See *supra* note 13. In *Clark*, the plaintiff had contracted to exchange his land in one state for an intervenor's farm in another state. The intervenor conveyed her farm to the plaintiff who, in turn, sold it and took a mortgage for the purchase price. 115 Iowa at 4, 87 N.W. at 697. Plaintiff failed to convey his land as agreed, and in his action against the defendant to foreclose the mortgage on what had been the intervenor's farm, the intervenor prayed for rescission of her contract with the plaintiff and subrogation to his rights under the mortgage. *Id.* at 5, 87 N.W. at 697. The court granted her prayer. *Id.* at 7, 87 N.W. at 698.

The above decisions aside, the use of tracing in breach of contract cases is largely unexplored in the case law. For a discussion of the issue, see generally 1 G. PALMER, *supra* note 1, § 4.10(a); Dawson, *Restitution or Damages?*, 20 OHIO ST. L.J. 175, 182-83 (1959); Recent Decision, 33 MICH. L. REV. 1290, 1290-91 (1935). A possible theory of tracing in such cases could be as follows: when an appropriate remedy for the defendant's breach is the return *in specie* of an asset transferred by the plaintiff, and this requires relief in equity (for example, a decree ordering the reconveyance of land), courts, drawing on their powers derived from the old equity courts, can operate through the use of the constructive trust. See, e.g., RESTATEMENT OF RESTITUTION § 160 (1936). If the plaintiff can claim a constructive trust on the transferred asset, he should also be able to claim a constructive trust over any of its products—that is, he should be able to trace into the products of the transferred asset.

The Restatement of Restitution, however, is not explicit on the matter. It notes that full tracing relief may be used only against the "conscious wrongdoer"—one who, for example, "obtains property from the claimant by fraud, duress or undue influence, or . . . intentional conversion of the property of the claimant." *Id.* § 202 comment b. Limited tracing relief applies against "innocent converts" (defendants who acquire stolen goods without knowledge, for example) and gratuitous donees. *Id.* §§ 203, 204. If courts allow tracing in contract cases, is a breaching party a member of the former or latter class? Or should the culpability of the breaching party be individually assessed in each case? *But cf.* Dawson, *supra* note 8, at 577 (the "distinction . . . between knowing and ignorant . . . should be irrelevant where restitution has been used by American courts in the unwinding of contracts."). Professor Palmer appears to favor very limited tracing in contract cases. He would allow tracing for a contract breach only to give the plaintiff limited aid in collecting his otherwise-available money judgment, by securing that judgment with specific traceable assets. See 1 G. PALMER, *supra* note 1, § 4.10(a). The lien is largely toothless, however, for Professor Palmer would not use it to grant priority over other creditors. See *id.* § 4.10(a), at 453.

The reason why the case law is sparse on the matter is easy to see. Claimants rarely request tracing because few cases grant specific relief in equity for the return of transferred property after a contract is broken. For example, in land sale cases, if a vendor conveys title without placing a condition subsequent or some analogous clause in the deed, and the vendee breaches, courts commonly deny specific restitution. *E.g.*, *Emigrant Co. v. County of Adams*, 100 U.S. 61 (1879); *Covington v. Butler*, 242 So. 2d 444 (Miss. 1970); *State v. LoBue*, 83 Nev. 221, 427 P.2d 639 (1967), *cert. denied*, 451 U.S. 971 (1981); see S. WILLISTON, WILLISTON ON CONTRACTS § 1456 (3d ed. 1970). Standard means exist for making the grantee's title defeasible on his breach through the reservation of either a power of termination or a possibility of

or the wrongful disposition of collateral by a debtor.¹⁷ In each of these situations, tracing doctrine provides an alternate remedy to a money judgment, or to a suit against a third party for the original property misappropriated. Indeed, the primary limitation on the scope of the right to trace is the ignorance of lawyers as to its availability.

Tracing is most useful to a claimant when it provides him with a

reverter, and the courts hesitate to give the grantor rights equivalent to those that he failed to retain expressly. A few exceptions to the general rule against specific relief exist, however, and, if appropriate, one could argue for tracing in these cases. The best-known exception arises when the plaintiff conveys land in consideration for the defendant's promise to provide the plaintiff support. If the grantee fails to provide support, the court will cancel the deed. *See, e.g.,* Caramini v. Tegulias, 121 Conn. 548, 186 A. 482 (1936); *see* R. POWELL, *supra* note 11, § 901. If such a defendant sells the land to a third party, some courts hold that because the grantor was the equitable owner of the land, the grantor may claim the proceeds of the second sale or the assets purchased with those proceeds, a tracing remedy. *See, e.g.,* Colby v. Street, 146 Minn. 290, 178 N.W. 599 (1920).

In contracts for the sale of personal property, in which the seller has parted with both possession and title, courts also regularly refuse the seller specific restitution of the goods if the buyer breaches. As with grantors of real property, courts are unwilling to accord the seller a de facto security interest in the goods when he has failed to preserve expressly such an interest for himself. Some statutory exceptions exist, however. For example, although the Uniform Commercial Code limits the seller to an action for the price, *see* U.C.C. § 2-709(1)(a) (1978), if the seller discovers that the buyer is insolvent, he may, in limited circumstances, reclaim the goods within 10 days of receipt. U.C.C. § 2-702(2) (1978). Cash sales, in which delivery and payment are intended to be concurrent, provide another exception. The seller can also reclaim the goods if the buyer acquires possession through a dishonored check. *In re* Mort Co., 208 F. Supp. 309 (E.D. Pa. 1962); U.C.C. §§ 2-507(2), 2-511(2), (3) (1978). Thus, tracing could be argued as applicable in those few cases in which the buyer sells or exchanges goods while the seller still has a right to reclaim them under § 2-702 or § 2-507. Section 2-702 cases may support the tracing argument better than do § 2-507 cases, however, because the seller's right of reclamation in cash sales is an outgrowth of a common law title theory. *See* S. WILLISTON, WILLISTON ON SALES § 341 (rev. ed. 1958); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1060-61 (1954) (title in cash sales is said not to pass until price is paid and hence seller can recover possession at law on strength of his title).

The application of tracing to contract cases, however, should not ultimately depend on the technicalities attendant to the old forms of equitable relief. Rather, two issues arise. First, should a breaching defendant—a vendor who sells land to a third party for more money, for example—retain any benefit? *See* 1 G. PALMER, *supra* note 1, § 4.9; Dawson, *supra*, at 186-89. Second, should traditional tracing rules measure that benefit? I favor a negative answer to both questions. The second issue is the subject of this article. The first issue is subject to considerable debate. An award to the plaintiff in excess of lost profits may deter breaches that we wish to encourage. *Compare* R. POSNER, ECONOMIC ANALYSIS OF LAW § 4.9 (2d ed. 1977) (lost profit measure ensures that we permit breaches that promote economic efficiency) with 1 G. PALMER, *supra* note 1, at 442. *See also* Marcneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

¹⁷ *See* U.C.C. § 9-306 (1978); *infra* notes 76-85. In a similar view, most American jurisdictions, either by statute or common law, permit creditors to claim property that the debtor conveys in order to frustrate creditors. *See generally* UNIFORM FRAUDULENT CONVEYANCE ACT §§ 4-8 (1918) (adopted in over 23 states). Under § 9 of the U.F.C.A., a creditor proving the existence of a fraudulent conveyance may bring an action to set the conveyance aside or ignore the transfer and levy on the property in the hands of the transferee. This right to claim the property in the hands of the transferee may arguably support tracing relief. For example, Debtor fraudulently conveys his automobile to Third Party. Third Party exchanges the automobile for a motorcycle. Can the creditors of Debtor trace into the motorcycle?

larger recovery than he would have received had he sought a simple money judgment.¹⁸ Frequently a careful lawyer can significantly aug-

¹⁸ A claimant's right to trace misappropriated property, whether the product is in the hands of the wrongdoer, a third person, or both, can pose tricky election-of-remedies issues. Initially, the claimant must choose between a money judgment (either in damages or in quasi-contract) and tracing. RESTATEMENT OF RESTITUTION § 16 comment e (1936); *id.* § 68. Early courts, consistent with the trust origins of the tracing doctrine, spoke of affirming the acts of the wrongdoer if tracing relief was selected and of disaffirming the acts of the wrongdoer if damages were sought. *See id.* § 68; Note, *Election of Remedies: A Delusion*, 38 COLUM. L. REV. 292, 294-95 (1938). A similar election to affirm the acts of the wrongdoer was said to occur if the plaintiff chose quasi-contract rather than damages as a method of calculating the size of a money judgment. The timing requirements imposed on the plaintiff's choice however can be troublesome. Great variety exists in the applicable rules, and unwary plaintiffs may find themselves unintentionally selecting a less-than-optimal remedy. *See generally* Hine, *Election of Remedies: A Criticism*, 26 HARV. L. REV. 707 (1918); Patterson, *Improvements in the Law of Restitution*, 40 CORNELL L.Q. 667, 679 (1955). *See also* Oesterle, *supra* note 9, at 343-50 (discussing *Roberts v. Sears, Roebuck & Co.*, 573 F.2d 976 (7th Cir.), *cert. denied*, 439 U.S. 860 (1978)). Some states require the plaintiff to make his election before the case is submitted to the court for factfinding. *See, e.g.*, *Billman v. Ace Restaurant Supply Co.*, 5 Ariz. App. 56, 423 P.2d 132 (1967); *Ajamian v. Schlanger*, 14 N.J. 483, 103 A.2d 9 (1954); *Z.D. Howard Co. v. Cartwright*, 537 P.2d 345 (Okla. 1975). Other states allow the plaintiff to take more than one theory to verdict. *See, e.g.*, *D.H. Overmyer Co. v. Kapplin*, 122 Ga. App. 51, 176 S.E.2d 207 (1970); *Melby v. Hawkins Pontiac, Inc.*, 13 Wash. App. 745, 537 P.2d 807 (1975). A few states apparently allow the trial judge to select the appropriate time for election. *See, e.g.*, *Lukaris v. Harrison Vending Sys., Inc.*, 28 A.D.2d 1019, 283 N.Y.S.2d 674 (1967). The election, of course, may be expressly declared in the pleadings or on the record before the court. The plaintiff may make the election in other ways, however, and without knowing that his acts constitute a permanent election. Some early authorities hold, for example, that if the plaintiff manifests an intent to seek damages before suit is filed, he is barred later from seeking restitutionary relief even though the defendant did not rely on the plaintiff's communication. *See* RESTATEMENT OF RESTITUTION § 68(1) (1936); Hine, *supra*, at 709-10.

The election between tracing and a money judgment is not without conditions. Under the traditional rule, if the plaintiff asks for tracing as a remedy for violations historically originating in the law courts (breach of contract and conversion, for example), the court must find that the legal remedy (in damages or in quasi-contract) is inadequate before it may grant tracing relief. *See American Sugar Refining Co. v. Fancher*, 145 N.Y. 552, 561, 49 N.E. 206, 209 (1895); *see also International Refugee Org. v. Maryland Drydock Co.*, 179 F.2d 284 (4th Cir. 1950). The condition is a product of an English jurisdictional rule that equity courts could not grant relief if an adequate legal remedy was available in the common law courts. *See* Z. CHAFEE, *SOME PROBLEMS OF EQUITY* 296-380 (1950). The classic reasons sustaining a claim that the legal remedy is inadequate are: (a) the property involved is unique and damages cannot replace it, (b) the damages cannot be ascertained with reasonable accuracy, or (c) the defendant is insolvent. *See* H. MCCLINTOCK, *HANDBOOK OF THE PRINCIPLES OF EQUITY* §§ 43-47 (2d ed. 1948). When law and equity merged in many American courts, the old rule remained to establish, in effect, priorities among various types of relief; legal relief was preferred to equitable relief when the legal remedy was "plain and adequate." *See Boyce's Ex'rs v. Grundy*, 28 U.S. (3 Pet.) 210 (1830). Thus, the right to use tracing as a remedy for some substantive claims may depend on its classification as solely an equitable remedy, a doubtful analysis in American jurisprudence. *See infra* note 28. Note, however, that even if one assumes that tracing relief is solely equitable, the adequacy test does not apply if the substantive right sued upon is based on doctrine developed by the equity courts. *See* D. DOBBS, *supra* note 1, at 60-61; H. MCCLINTOCK, *supra*, at 102. Thus, all breaches of fiduciary duty may subject the offender to tracing relief regardless of the adequacy of a money judgment. *See, e.g.*, *Noble v. Noble*, 198 Cal. 129, 243 P. 439 (1926). Where the adequacy test does apply, some modern commentators argue that the mere fact that the tracing remedy is more advantageous to the

ment his client's recovery by choosing tracing relief.¹⁹ For example,

plaintiff satisfies the adequacy standard. G. BOGERT, *supra* note 11, § 472; 1 G. PALMER, *supra* note 1, § 2.19, at 218; *cf.* Jennings & Shapiro, *The Minnesota Law of Constructive Trusts and Analogous Equitable Remedies*, 25 MINN. L. REV. 667 (1941) (adequacy doctrine is immaterial to tracing because the equitable ownership right predates the court decree). *But see* J. DAWSON, *supra* note 10, at 32:

The notion of an equitable ownership, produced by tracing, appears most clearly in those exceptional cases where the constructive trustee is solvent and a money judgment remedy appears entirely adequate. The modern cases that hold this factor irrelevant seem to me to provide the most perfect example of circularity.

Some courts agree with Professor Dawson, but others do not; many apparently ignore the issue (perhaps as a result of defendants' failure to raise it properly). *See* 1 G. PALMER, *supra* note 1, § 2.190. In any event, although the initial reason for the adequacy doctrine—the deference of equitable courts to the jurisdiction of the legal courts—has long been abandoned, the doctrine retains surprising vitality. *See* *Snepp v. United States*, 444 U.S. 507, 526 (1979) (Stevens, J., dissenting) (“[F]or centuries the English-speaking judiciary refused to grant equitable relief unless the plaintiff could show that his remedy at law was inadequate.”). The survival of the doctrine should depend on a formulation of new moorings: namely, do the priorities in type of relief have some valid policy justification? The position of most modern commentators, diluting the adequacy test to a choice of the most advantageous remedy, implicitly answers in the negative.

Once the claimant elects tracing relief, a second election is necessary if the misappropriated property or its products are found in the hands of one or more third parties. The victim must choose between recovering the property held by the third party and recovering the traceable property held by the wrongdoer. For example, Wrongdoer, in breach of trust, sells land to Transferee, who takes with notice of the breach. If Owner could proceed against both Wrongdoer and Transferee without election between them, he could claim a double recovery—a constructive trust on the sale proceeds in the hands of Wrongdoer and also a claim to the land in the hands of Transferee. To prevent this, courts attempt to force the claimant either to sue Wrongdoer for the sales proceeds and Transferee for delivery of the property with credit for the sales price, or to sue Transferee alone for delivery of the property without a credit for the sales price. *Suarez v. de Montigny*, 1 A.D. 494, 37 N.Y.S.2d 503 (1896) (purchaser not given credit for purchase price because beneficiaries did not recover proceeds of sale from trustee). Even in the latter election if the trust has been actually credited with part of the payment price by the wrongdoer, the court must similarly credit the Transferee if the property in his hands is returned. *See, e.g., King v. Richardson*, 136 F.2d 849, 865 (4th Cir.), *cert. denied*, 320 U.S. 777 (1943) (“[T]he transferee is entitled to credit for the amount which he paid for the trust property to the extent to which the trust estate has the benefit thereof.”); *Marx v. Clisby*, 130 Ala. 502, 511-12, 30 So. 517, 521 (1900) (“It is deemed unconscionable that the heirs or devisees shall reap the fruits of the purchaser's payment of money, appropriated to the discharge of debts which were a charge on the lands, and at the same time recover the lands.”).

¹⁹ The choice also may affect the plaintiff's right to a jury trial. A constitutional right to a jury trial in cases “at common law” exists in the federal courts. *See* U.S. CONST. amend. VII. Most states have a similar provision. *See, e.g.,* N.Y. CONST. art. I, § 2 (1894) (amended 1938). Recent Supreme Court opinions suggest that the type of relief requested, not the procedural character of the action, determines whether the right exists. *See, e.g., Ross v. Bernhard*, 396 U.S. 531, 538 n.10, 542-43 (1970) (although derivative suit is a creature of equity, jury trial is required because the plaintiff sought damages for breach of contract and negligence). *See also Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 478 (1962) (request for simple accounting is a legal remedy, based on old common law action of account). Thus, if tracing is deemed to be an equitable remedy, *see infra* note 28, a demand for tracing relief may defeat a plaintiff's request for a jury trial. The issue is not free from considerable confusion. Language in Supreme Court cases arguably suggests that the Court would provide a jury trial to plaintiffs who seek equitable relief on common law violations for which the legal remedy is

against a solvent wrongdoer, tracing may provide the claimant with more than he lost by permitting recovery of an asset that is more valuable than the misappropriated property.²⁰ Against an insolvent wrongdoer tracing may augment the claimant's recovery under a money judgment by: (1) giving him priority over other claimants;²¹ (2) enabling him to reach otherwise exempt assets;²² or (3) allowing him to sue solvent third parties who have traceable property.²³ More than one of

inadequate. Presumably, the Court would grant a jury trial on the legal issues and then add equitable remedies consistent with the jury's verdict. Therefore, the fact that tracing is an equitable remedy would not by itself determine whether the plaintiff had a right to a jury trial; the nature of the substantive claim would be determinative. In contrast, some commentators argue that the Supreme Court has recast the law-equity distinction for purposes of the seventh amendment into a "simpler" distinction between money judgments and *in personam* orders, such as injunctions or specific performance. See, e.g., D. DOBBS, *supra* note 1, at 78. This distinction, however, is not always "simpler" and questions still remain: because a constructive-trust decree is traditionally an *in personam* order for the return of identified property, does the plaintiff lack any right to a jury trial if constructive-trust relief is requested? What is an equitable lien under this test? Although traditionally viewed as an *in personam* command, in effect an equitable lien serves merely to secure a money judgment.

²⁰ For example, if Wrongdoer embezzles \$10,000 from Owner, and with the funds purchases land that increases in value to \$15,000, Owner may claim the land and receive a windfall of \$5,000. See, e.g., *Fidelity & Deposit Co. v. Stordahl*, 353 Mich. 354, 91 N.W.2d 533 (1958) (when misappropriated money used to purchase real estate or personal property of any kind, beneficiary entitled to property); *Thompson v. Nesheim*, 280 Minn. 407, 159 N.W.2d 910 (1968) (when misappropriated money used as partial payment on property, beneficiary entitled to equal share in improved property); *Nebraska Nat'l Bank v. Johnson*, 51 Neb. 546, 71 N.W. 294 (1897) (when misappropriated money used to buy property, beneficiary entitled to improved property).

²¹ *Republic Supply Co. v. Richfield Oil Co.*, 79 F.2d 375 (9th Cir. 1935) (claimant given priority in receivership); *In re Kountze Bros.*, 79 F.2d 98 (2d Cir. 1935) (claimant given priority in bankruptcy); *Atlas, Inc. v. United States*, 459 F. Supp. 1000 (D.N.D. 1978) (claimant given priority over federal tax lien); *Powell v. Missouri & Ark. Land & Mining Co.*, 99 Ark. 553, 139 S.W. 299 (1911) (claimant given priority in administration of insolvent decedent's estate); *Lucianna v. Hip Sing Ass'n*, 256 A.2d 898 (D.C. 1969) (claimant given priority over judgment creditor); *Meyner v. Burlington-Bristol Bridge Co.*, 29 N.J. 210, 148 A.2d 585 (1959) (claimant given priority over partnership creditor).

²² The two major examples of exempt assets that ordinary creditors cannot reach are homestead property and life insurance proceeds. Courts, however, regularly allow tracing into both. See, e.g., *Shinn v. McPherson*, 58 Cal. 596, 599 (1881) (homestead laws not meant "to be a secure and impregnable asylum in which to deposit speculations from others"); *Jones v. Carpenter*, 90 Fla. 407, 106 So. 127 (1925) (homestead property); *Long v. Earle*, 277 Mich. 505, 520, 269 N.W. 577, 582 (1936) (court restricted relief to a lien on homestead property but stated "it was never contemplated or intended . . . that a homestead could be created and maintained with stolen or embezzled property, or with property wrongfully converted which rightfully belonged to the beneficiaries of a trust fund"); see also G. BOGERT, *supra* note 11, § 925 (life insurance); 5 A. SCOTT, *supra* note 1, § 508.4 (life insurance); Annot., 24 A.L.R.2d 672 (1952) (life insurance); Annot., 43 A.L.R. 1415 (1926) (homestead property).

²³ Tracing doctrine operates against innocent transferees who receive no legal title and transferees who are not bona fide purchasers and receive legal but not equitable title. If either type of transferee exchanges the acquired property for other property, or receives income from the acquired property, tracing may apply. See RESTATEMENT OF RESTITUTION §§ 204, 205 (1936); *infra* note 159-98 and accompanying text; see also *Hartford Nat'l Bank v. Westchester Fed. Sav. & Loan Ass'n*, 555 F.2d 1122 (2d Cir. 1977); *Air Traffic Conference v. Downtown Travel Center*, 87 Misc. 2d 151, 383 N.Y.S.2d 805 (Sup. Ct. 1976); *Banes Estate*,

these advantages may arise in the same case. For example, a claimant may trace an asset into the hands of an insolvent defendant when the asset is worth more than the claimant's actual loss.²⁴ The plaintiff in such a case is able not only to claim appreciated property, but also to achieve priority over other creditors.

Although tracing is viewed as a remedy, it is itself implemented through a number of more specific remedial devices: constructive trust, equitable lien, and subrogation. For example, if a trustee wrongfully sells or exchanges the trust res for other property and personally retains the product, the wronged beneficiary may claim an equitable ownership interest in the substitute assets. This proprietary right in the substitute assets derives from the beneficiary's equitable interest in the trust res and, therefore, is subject to his ability to identify assets in the hands of the trustee that can be traced through a series of exchanges back to trust property. The beneficiary is entitled to exercise his proprietary right in the substitute assets either by obtaining a constructive-trust decree ordering the errant trustee to transfer the assets *in specie* to the beneficiary,²⁵ or by enforcing an equitable lien upon the assets equal to the

452 Pa. 388, 305 A.2d 723 (1973). In some cases, tracing merely secures a victim's recovery against the transferee on nontracing theories of relief by creating an equitable lien on specific property. In other cases, tracing augments other forms of recovery by reaching the "direct product" income in the hands of the transferee and, in a few cases, tracing provides the sole basis of relief against a transferee. The last circumstance is illustrated as follows: Wrongdoer acquires a cow from Owner through fraud. Wrongdoer gives the cow to Donee, who has no notice of the fraud and pays no value. Donee exchanges the cow for some sheep. Tracing permits Owner to assert an equitable ownership interest in Donee's sheep.

²⁴ Professors Palmer and Scott disagree on whether specific restitution is proper in this case. Compare 1 G. PALMER, *supra* note 1, § 2.14 ("When the claim is against an insolvent estate . . . the controversy is essentially between the claimant and general creditors of the insolvent, and the claimant usually should be limited to recovery of the amount taken from him.") with 5 A. SCOTT, *supra* note 1, § 508 ("It is immaterial that the wrongdoer is insolvent, for his creditors, not being purchasers for value, are not entitled to any interest in the claimant's property or its product."). The Restatement of Restitution reflects the views of its author, Professor Scott. See RESTATEMENT OF RESTITUTION § 202 comment e (1936). See also *Kemp v. Elmer Co.*, 56 F.2d 657, 658 (S.D. Cal. 1932), *modified*, 67 F.2d 948 (9th Cir. 1933) (adopting Professor Scott's approach); *Smith v. Township of Au Gres*, 150 F. 257, 261 (6th Cir. 1906) (adopting Professor Palmer's approach).

²⁵ In a constructive-trust case, the defendant is said to hold the property as trustee for the plaintiff and has an equitable duty to convey that property to the plaintiff. *Massachusetts Bonding & Ins. v. Josselyn*, 224 Mich. 159, 162, 194 N.W. 548, 549 (1923). Thus, the typical decree orders the defendant to transfer title in the property to the plaintiff. *Jud Whitehead Heater Co. v. Obler*, 111 Cal. App. 2d 861, 245 P.2d 608 (1952); *Nebraska Nat'l Bank v. Johnson*, 51 Neb. 546, 71 N.W. 294 (1897). Originally equity operated solely *in personam*, so that the court could not vest title in the plaintiff through the constructive-trust decree, but could only order, with threat of contempt, that the defendant effect a transfer of title to the plaintiff. See C. HUSTON, *THE ENFORCEMENT OF DECREES IN EQUITY* (1915). The merger of law and equity and the evolution of the constructive-trust remedy, however, have led courts to decree routinely that a constructive-trust judgment vests title. See, e.g., *Buggell v. Edward H. Everett Co.*, 180 F. Supp. 893 (D. Vt. 1960); *McCreary v. Shields*, 333 Mich. 290, 296, 52 N.W.2d 853, 856 (1952).

value of the misappropriated trust res.²⁶ The beneficiary's choice, of course, will depend on the value of the substitute assets at the time of judgment.²⁷

The thesis of this article is that tracing is largely unprincipled; more often than not it fails to implement the principle of unjust enrichment, which is the heart of restitutionary theory. Tracing often overstates the defendant's gain from the misappropriation and discriminates unreasonably between victims of misappropriation, between the defendant's creditors and the victims of misappropriation, and between innocent third parties who receive property from the defendant. The argument proceeds as follows. Section II explains the origins and growth of tracing and distinguishes the argument in this article from other recent criticisms of tracing relief. Sections III and IV explain the theoretical deficiencies in the doctrine. Inappropriate applications of the doctrine

²⁶ RESTATEMENT OF RESTITUTION §§ 161, 202 (1936). An equitable lien decree orders the holder of the property subject to the lien to pay the amount of the lien or suffer execution on the identified property. The most often cited early explanation for the choice between a constructive trust and an equitable lien is the following passage from *In re Hallett's Estate*, 13 Ch. D. 696 (1879):

[T]he beneficial owner has a right to elect either to take the property purchased, or to hold it as a security for the amount of the trust money laid out in the purchase; or, as we generally express it, he is entitled at his election either to take the property, or to have a charge on the property for the amount of the trust money.

Id. at 709. For other cases supporting the choice between a constructive trust and an equitable lien, see *Loring v. Baker*, 329 Mass. 63, 106 N.E.2d 434 (1952); *Thompson v. Nesheim*, 280 Minn. 407, 159 N.W.2d 910 (1968); *McGurk v. Moore*, 234 N.C. 248, 67 S.E.2d 53 (1951).

Tracing may also result in a decree for subrogation if the trustee uses traceable property in discharging an obligation owed by the trustee or a lien upon other property of the trustee. *Cotton v. Dacey*, 61 F. 481 (D. Kan. 1894); *Whalen v. Marling*, 176 Wis. 441, 187 N.W. 169 (1922). In such a situation, the court gives the plaintiff rights similar to those that the obligee or lien-holder enjoyed before the lien was discharged. The plaintiff is said to be subrogated to the position of the obligee or lien-holder. If the trustee wrongfully used traceable property to discharge the debt or lien at a discount, the beneficiary is entitled to be subrogated for the full amount of the debt or lien and thus may profit from the subrogation. *See* RESTATEMENT OF RESTITUTION § 162 comment i (1936).

²⁷ Consider the following example. Wrongdoer is the trustee of Blackacre for the benefit of Beneficiary. In breach of the trust, Wrongdoer exchanges Blackacre for personal title to Greenacre. At the time of the exchange Blackacre is worth \$100,000. If Greenacre is worth \$150,000 at the time of judgment, Beneficiary may claim Greenacre and secure a handsome profit (assuming that the interest collectible on a personal judgment against Wrongdoer is less than \$50,000) by charging Wrongdoer as a constructive trustee. If Greenacre, at the time of judgment, is worth \$90,000, Beneficiary may enforce an equitable lien on Greenacre for \$100,000 (plus interest if allowed). The land is then sold; Beneficiary receives the \$90,000 in proceeds and has a residual personal claim against Wrongdoer for the deficiency.

The different forms of relief—equitable lien, constructive trust, and subrogation—may be combined to maximize the plaintiff's recovery. Thus, if Wrongdoer sells Blackacre in breach of trust for \$100,000, and uses \$90,000 of the proceeds to buy Greenacre (worth \$150,000 at the time of judgment), and uses \$10,000 to buy Whiteacre (worth \$5,000 at the time of judgment), then Beneficiary can claim title to Greenacre through a constructive trust decree and enforce an equitable lien of \$10,000 on Whiteacre. This yields \$5,000 in proceeds through an execution of the lien and a residual claim against Wrongdoer of \$5,000.

augment the significance of these deficiencies; tracing is too often allowed to override and distort the remedial schemes of the bodies of law addressing distinct policy issues. To illustrate this theme, section V focuses on creditors' remedies against insolvent debtors, and section VI examines the harsh effect of the doctrine on innocent transferees of misappropriated property. If I am correct, courts should curtail the use of tracing, and courts and legislatures should reconsider statutory schemes that adopt tracing principles, like Article Nine of the UCC. Finally, in section VII, I note that the same arguments used against tracing apply against other restitutionary doctrines, particularly the flagship of restitution—quasi-contract. Thus, other rules in the law of restitution should also be reconsidered in light of their efficacy in measuring unjust enrichment.

II

THE ORIGIN AND GROWTH OF TRACING

The doctrine of tracing evolved over several hundred years. Its birth was understandable: to provide relief against errant trustees, English equity courts granted beneficiaries a proprietary right to follow misappropriated property into its product.²⁸ This derivative right in traced

²⁸ There is vigorous debate in England over the scope of a right to trace at common law. See, e.g., Goode, *The Right to Trace and Its Impact in Commercial Transactions*, 92 LAW Q. REV. 360 (1976); Khurshid & Matthews, *Tracing Confusion*, 95 LAW Q. REV. 78 (1979); Pearce, *A Tracing Paper*, 40 THE CONVEYENCER 277 (1976); Scott, *The Right to "Trace" at Common Law*, 7 U.W. AUSTL. L. REV. 463 (1966). The debate may affect the right to a jury trial of those who seek to trace in this country's courts. See *supra* note 19.

The argument centers around the case of *Taylor v. Plumer*, 3 M. & S. 562, 105 Eng. Rep. 721 (1815) (Ellenborough, J.). In *Taylor* the defendant gave his broker a banker's draft with instructions to buy exchequer bills on the defendant's account. The broker used part of the proceeds to buy other securities and bullion for his own account. The broker then became insolvent and tried to flee the country, but was caught by the defendant. The broker had the securities and bullion in his possession and the defendant appropriated them. The broker's assignees in bankruptcy sued the defendant in trover for the property. The suit failed, however, because the defendant argued successfully that he owned a beneficial interest in the property:

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

Id. at 575, 105 Eng. Rep. at 726.

Early American textbook writers believed that because the defendant could trace into the securities and bullion to *defend* in trover, the case allowed a plaintiff to trace and to *sue* in trover or detinue (if, for example, the assignees rather than the client had caught the fleeing broker and the client sued the assignees for the securities and bullion). E.g., 2 J. STORY, *supra* note 13, § 1258, at 503-04. American decisions repeated Justice Story's error. See, e.g., *Oliver v. Pialt*, 44 U.S. 333, 401 (1845). The writers overlooked the fact, however, that for the defendant to become a plaintiff in trover or detinue he would have to sue in the name of the broker, who retained legal title. The defendant could have sued the assignees in his own name only in the equity courts. The tracing language of the opinion only rebutted the assign-

assets was a fictional extension of the beneficiary's fluid equitable ownership interest in the trust res: the beneficiary's interest in the trust res survived through changes in the form of the trust property arising from proper res management.²⁹ In early tracing cases, the equity courts merely extended the beneficiary's proprietary interest in the trust res to

ees' argument that the broker's abuse of his authority terminated the defendant's beneficial interest; the language did not assert tracing to be an at-law remedy. Rather, the passage describing the right to trace as preserving the defendant's beneficial interest merely restated equity-court law applicable to disobedient trustees. Thus, the opinion does not define a right to trace at common law. See generally Khurshid & Matthews, *supra* at 79-82 (1979). Even those who find a common law right to trace in the case law would not support a plaintiff's claim in a case like *Taylor v. Plumer* for the return of the property *in specie*—the traditional form of tracing in equity; rather, they would transform the claim into an extension of the action for money had and received. See R. GOFF & G. JONES, *supra* note 1, at 49 (debate among English writers is often confusing because they conflate two types of exchanges: transfers of misappropriated property from one person to another, such as a trustee in bankruptcy, and exchanges by one person of misappropriated property for substitute property).

The current vitality of the English controversy over a common law right to trace stems from the refusal of English courts to trace in equity absent the existence of a fiduciary relationship between the plaintiff and the defendant or an intermediary. See *In re Diplock*, 1 Ch. 465, 530 (Ch. App. 1948). Accordingly, if English courts could be persuaded to recognize a common law right to trace, it would be broader than the equitable right because the plaintiff would not need to show that the defendant, or any involved third party, is a fiduciary. R. GOFF & G. JONES, *supra* note 1, at 53.

For years American courts could afford to be lax on the matter because they do not require a fiduciary relationship for tracing relief in equity. See *supra* notes 12-16 and accompanying text. Thus, in *Newton v. Porter*, 69 N.Y. 133, 137 (1877) the court could avoid the issue of whether there is a common law right to trace when faced with a nonfiduciary misappropriation:

It is not necessary to decide that, in the case supposed, [the victim of the theft] would have the legal title to the [product of the stolen goods], but if that question was involved in the case I should have great hesitation in denying the proposition. That she could assert an equitable claim to the money, I have no doubt.

The courts may soon have to face the problem directly, however, now that the Supreme Court has arguably concluded the constitutional right to a jury trial depends on the character of the remedy. See *supra* note 19 and accompanying text.

A theoretical problem with common law tracing that has not been carefully considered concerns the role of the bona fide purchaser. Equitable tracing does not affect bona fide purchasers because their purchase cuts off equitable rights in the subject property. Tracing at law, however, would rest on notions of legal title, and bona fide purchasers are subject to legal title claims. Cf. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1060-61 (1965) (discussing remedies in breached cash sales as legal title controversies). Therefore, if tracing were permitted at law, bona fide purchasers theoretically may be subject to extensive tracing claims that they have heretofore avoided. Courts are not likely to go along, however. See, e.g., *Cole v. Bates*, 186 Mass. 584, 72 N.E. 333 (1904).

²⁹ Known originally as an "active use," this type of trust, in which the feoffee (the recipient of a grant of land in fee simple) had positive duties to perform at the direction of the feoffor (the transferor of legal title), survived the Statute of Uses in 1536. Common provisions in these early active uses included those directing the feoffees to raise money out of the transferred land for the payment of debts, for marriage portions, and for religious or other charitable contributions to aid the donor's soul. See S. MILSOM, HISTORICAL FOUNDATIONS OF THE COMMON LAW 233-36 (2d ed. 1981). A good early discussion of the nature of the beneficiary's interest in the trust res is contained in Lord Justice Turner's opinion in *Pennell v. Deffell*, 4 De G. M. & G. 372, 372-89, 43 Eng. Rep. 551, 551-59 (1853).

include *unauthorized* changes in form. The Chancellors refused to crystallize the beneficiary's interest in the trust res upon the occurrence of the wrongful misappropriation by the trustee. Thus, the courts allowed a beneficiary to elect to affirm the illegal acts and "trace" his property through wrongful exchanges.³⁰ Alternatively stated, at the plaintiff's election a court would presume conclusively that the errant trustee had acted with proper authority when the exchange was made. This simple fiction of regularity was the seed of all current tracing doctrine.³¹

³⁰ Jessel, M.R., explained the argument in 1879:

The modern doctrine of Equity as regards property disposed of by persons in a fiduciary position is a very clear and well-established doctrine. You can, if the sale was rightful, take the proceeds of the sale, if you can identify them. If the sale was wrongful, you can still take the proceeds of the sale, in a sense adopting the sale for the purpose of taking the proceeds, if you can identify them. There is no distinction, therefore, between a rightful and a wrongful disposition of the property, so far as regards the right of the beneficial owner to follow the proceeds.

In re Hallet's Estate, 13 Ch. D. 696, 708-09 (1879).

³¹ The very early Chancery cases dealing with tracing suggest an intermediate step in its evolution. In *Whitecomb v. Jacob*, 1 Salk. 160, 91 Eng. Rep. 149 (1710) and *Lane v. Dighton*, 1 Amb. 409, 27 Eng. Rep. 273 (1762), early cases on constructive trusts, the fiduciaries *intended* to subject the newly acquired asset to the trust obligation but failed to do so. See also *Ryall v. Rowles*, 1 Ves. Sen. 348, 363, 27 Eng. Rep. 1074, 1083 (1749-50). Thus, these early tracing cases arguably created an equitable interest in the beneficiary only under limited conditions. First, the trustee sold the trust res with the intention of subjecting the sale proceeds to the beneficiary's interest. Second, the retransfer of those proceeds to the beneficiary's account was frustrated because of a failure to comply with the Statute of Frauds (as in *Lane*) or a lack of effective delivery (as in *Whitecomb*). See *Khurshid & Matthews, supra* note 28, at 79-80.

The case of *Halcott v. Markan*, Prec. Ch. 168, 24 Eng. Rep. 81 (1701), provides the clearest support for this limited view of tracing. In *Halcott*, an executor was empowered by will to use estate assets to purchase land for an heir. The executor purchased land in his own name after obtaining the consent of the heir's mother. No trust documents were ever signed declaring the heir to be the beneficiary, however, and the executor died insolvent. The heir sought the land and the Master of the Rolls "was very inclinable to help the plaintiff as far as might be." *Id.* at 169, 24 Eng. Rep. at 81. The Court, therefore, distinguished *Kirk v. Webb*, Prec. Ch. 85, 24 Eng. Rep. 41 (1698), see *supra* note 10, "for there the party did not know himself to be a trustee," but nonetheless refused to hold for the heir on other grounds (there was "no express proof of the application of the trust money"). Prec. Ch. at 169, 24 Eng. Rep. at 81.

As late as 1813, a respected barrister was arguing yet another limitation based on the intent of the *beneficiary*, although he recognized that at least one case was not in accord with his views:

It might perhaps be contended, too, that according to the doctrine—that where a purchase is made in the name of *one* person, and the purchase money belongs to *another*, that there a trust arises by implication of law in favor of the person to whom the money belonged; I say it might perhaps, be contended, that according to this doctrine, the parties would be entitled to the estate itself. But the doctrine just noticed only applies, I apprehend, to cases where the parties to whom the money belonged *intended* it to be laid out either in the specific purchase, or, generally, in some purchase. Upon the whole I should be inclined to think, that the parties entitled to the trust money *not intended* to be laid out in lands, would only be entitled to a *lien* on the estate.

E. ATHERLEY, A PRACTICAL TREATISE OF THE LAW OF MARRIAGE AND OTHER FAMILY SETTLEMENTS 444 (emphasis in original) (footnotes omitted) (1813). Justice Story, in his

Once created, however, the doctrine crept inexorably into disorderliness.³² Courts extended the equitable ownership concept to ever-widening classes of cases, peaking with the "swollen asset" rule found in a few of the bank failure cases of the 1930s.³³ At about the same time,

influential treatise on equity, found "much sound sense in the distinction," but agreed that the authorities did not support it. See 2 J. STORY, *supra* note 13, § 1210, at 457 n.1.

³² See J. DAWSON, *supra* note 10, at 149-50.

³³ The high-water mark of tracing came in the early 1930's when depositors in numerous bank failures found their accounts empty and were unable to trace their funds into any identifiable fund or property of the insolvent bank. The depositors were left to squabble among each other and with the bank's other creditors for a share of the remaining assets. Courts in a few states, moved by the plight of some of the victims, recognized a "swollen asset" or "augmentation" theory of tracing that gave these select depositors priority over other kinds of creditors. See, e.g., *Word v. Sparks*, 191 Ark. 893, 82 S.W.2d 5 (1935); *Rackley v. Mathews*, 141 Fla. 307, 193 So. 69 (1940); *Eastman v. Farmers' State Bank*, 175 Minn. 336, 221 N.W. 236 (1928); *Nelson v. Estate of McClean*, 236 Mo. App. 718, 161 S.W.2d 676 (1942); *First Trust Co. v. Exchange Bank*, 126 Neb. 856, 254 N.W. 569 (1934). Numerous writers supported the movement. See, e.g., *Hirsch, Tracing Trust Funds—Modern Doctrine*, 11 TEMP. L.Q. 11 (1936); see also *Taft, A Defense of a Limited Use of the Swollen Assets Theory Where Money Has Wrongfully Been Mingled With Other Money*, 39 COLUM. L. REV. 172, 174 (1939); *Note, Presumptions in Aid of The Custui of a Money Trust After the Trustee's Insolvency*, 26 COLUM. L. REV. 730 (1926); *Note, Priority in the Assets of a Bankrupt Fiduciary or Converter*, 51 HARV. L. REV. 143 (1937); *Note, Trusts—Tracing of Assets—Preference*, 30 MICH. L. REV. 441 (1932). Under this new theory, if the plaintiff could prove some equitable wrong by the bank against him, he was excused from specifically tracing his lost funds into products of exchanges or into commingled funds. The mere fact that the bank wrongfully dealt with plaintiff's assets entitled him to an equitable lien on the bank's entire estate for the full amount of his loss. This lien gave the plaintiff priority over other general creditors. Thus, if the bank were a fiduciary and the beneficiary could argue that the bank breached its duties, he could claim an equitable lien on any asset in the hands of the insolvency trustee. Similarly, if a depositor could prove that the bank either wrongfully commingled his assets with those of other depositors, or fraudulently received a deposit while knowing that bankruptcy was imminent, he could claim an equitable lien for his loss.

The swollen assets theory has far-reaching implications. It completely rids tracing of its property heritage by eliminating equitable ownership of identifiable property as the basis of relief. In addition, the theory, if applicable beyond bank failures, grants victims of equitable wrongs priority over all other creditors in a wide variety of circumstances. For example, if Wrongdoer steals Owner's money and dissipates it by buying necessities, Owner can claim not only damages for his loss, but also an equitable lien on any of Wrongdoer's assets to secure that loss. Accordingly, Owner has a claim on Wrongdoer's assets superior to that of other general, and possibly other secured, creditors. Why should this be so? If Wrongdoer had not used Owner's money, the argument goes, Wrongdoer would have used his own, depleting his funds subject to claims by his other creditors. Perhaps one could argue further that, if at the same time Wrongdoer used Owner's money on the necessities, Wrongdoer also used an equivalent amount of his own money to buy property that later appreciated, Owner should be able to claim that appreciated property; Wrongdoer's use of Owner's money on necessities enabled him to profit by investing his own money.

Most courts, in accord with Restatement of Restitution, now reject the swollen assets theory on the ground that the money wrongfully taken does not augment the wrongdoer's assets that are available to the general creditors. See RESTATEMENT OF RESTITUTION § 215 (1937); *G. BOGERT, supra* note 11, § 922 at 374-78; *1G. PALMER, supra* note 1, § 2.14 ("At the time that the wrongdoer's assets were swelled by the claimant's funds, he incurred a liability to the claimant in an equal amount."). This rebuttal is largely unsatisfactory. Although the wrongdoer's estate is subject to the victim's claim for the wrongfully appropriated funds, the victim, if not granted a priority in distribution, will have his claim diluted by the equivalent

American legal theorists, recognizing perhaps that tracing was in need of a sound policy foundation, subsumed the doctrine under the rubric of "unjust enrichment," and defended tracing on the ground that it requires defendants to disgorge benefits unjustly obtained at the plaintiff's expense. Tracing is largely so justified today. Even as thus rationalized, the law of tracing is subject to serious deficiencies. The principle of unjust enrichment cannot be defensibly invoked to justify most of the numerous applications of tracing.

Courts that employ tracing solely as a method of redressing instances of unjust enrichment are in essence using it as a crude rule of thumb for calculating the extent of a defendant's gain from a wrongful appropriation. So employed, tracing becomes a complicated facade for a rough doctrine of causation. In essence, when a claimant traces property into its product in the hands of the defendant, courts conclusively assume: (a) that the defendant has benefited at the claimant's expense; and (b) that the amount of the benefit is the value of the traceable product. In contrast, courts assume that a claimant who cannot trace is unable to demonstrate that a wrongdoer has benefited beyond receiving the value of the misappropriation. Courts measure this value at the time of the misappropriation or at the time of the wrongdoer's subsequent exchange of the subject property. The simple statement of the assumptions ought to invite skepticism. Indeed, as is discussed in section

claims of other creditors. Thus, the victim does not receive full compensation, and his loss augments the defendant's estate to the benefit of the other creditors. For example, Wrongdoer, who has \$100 in assets, owes \$100 each to two general creditors, Creditor-One and Creditor-Two, and wishes to pay Creditor-One in full. In Case *A*, Wrongdoer gives Creditor-One his \$100 asset and Creditor-Two is left with nothing upon which to execute. In Case *B*, Wrongdoer steals \$100 from Owner and gives it to Creditor-One. Wrongdoer's estate is left with only the original \$100 asset. If Owner is not granted a priority in Wrongdoer's estate, Creditor-Two can collect \$50 and Owner can collect \$50. Thus, Wrongdoer's estate in Case *B* is "swollen" from Creditor-Two's point of view, and he has gained as a result of the theft at Owner's expense.

The swollen-assets theory may currently survive in a limited class of cases, those in which a broker misappropriates a customer's securities. Two early Supreme Court cases established this exception. *Gorman v. Littlefield*, 229 U.S. 19 (1913); *Duel v. Hollins*, 241 U.S. 523 (1916). The *Restatement* incorporates the exception: "Where a broker wrongfully disposes of the securities of a customer, the customer is entitled to claim in substitution therefor securities of the same issue owned by the broker." RESTATEMENT OF RESTITUTION § 215b (1936); see also Oppenheimer, *Rights and Obligations of Customers in Stockbroker Bankruptcies*, 37 HARV. L. REV. 860, 874 (1924). Thus, if a broker wrongfully sells the securities of a customer, and the proceeds of the sale cannot be traced, the customer can claim specifically other securities of the same issue from the broker's personal account. Customers therefore who can find matching securities in a broker's personal account acquired any time after the wrongful misappropriation can secure a preference in insolvency without specific tracing of the misappropriated securities. The preference, of course, is at the expense of the other creditors. Although the rule appears to be a particular version of the otherwise expressly rejected swollen-assets theory, the Restatement of Restitution fails to explain why the general creditors of securities brokers should be worse off than the general creditors of bankers *vis à vis* victims of fiduciary breaches.

III, they consistently overcalculate the extent of the defendant's benefit in cases in which the courts allow tracing; and as is discussed in sections IV through VII, they create distinctions among both claimants and defendants that do not correspond to the facts of the cases. These systemic errors cannot be explained as pragmatic short-cuts necessary for workable judicial administration of the unjust enrichment principle; more accurate and yet equally practical rules are possible.

Tracing has attracted its share of critics. In the last fifty years there has been an intermittent but persistent flow of writing aimed at controlling the reaches of tracing doctrine. Nonetheless, the movement does not offer a sufficient reanalysis; its members appear willing to accept the basic tracing assumptions if selectively modified. Beginning with a student Comment in the *Yale Law Journal* in 1925,³⁴ commentators began to question the use of tracing principles in select cases in which a traditional application of the doctrine led to inequitable results. The Yale Comment, for example, argued that courts should not use tracing to penalize the beneficiaries of life insurance proceeds for the wrongs of the deceased.³⁵ Because this comment typifies most modern arguments to limit tracing relief, it merits closer inspection.

Assume that a trustee wrongfully takes trust funds and invests them directly in a life insurance policy payable to his children. The trustee dies early and the policy pays proceeds well in excess of the invested premiums. Traditional tracing permits the trust beneficiary to argue that because he is the equitable owner of the premiums and, through tracing, the equitable owner of the proceeds, he may claim the entire proceeds, to the exclusion of the children. The beneficiary thus makes a tidy profit—perhaps even well in excess of what he would have received otherwise as a return on his funds—and the children retain nothing.³⁶ Most modern commentators agree with the Yale Comment that the beneficiary should recover from the proceeds only his actual loss, leaving any excess for the policy's beneficiaries.³⁷ Here the choice is not be-

³⁴ Comment, *Rights of a Dependent Beneficiary Under Insurance Policies Procured With Misappropriated Funds*, 35 *YALE L.J.* 220 (1925). The beginning of the movement might also be Professor Ames's article in 1906, in which he distinguished on moral grounds the innocent and willful converter. See generally *infra* note 159. In the case of life insurance, however, Professor Ames followed the traditional rule. See Ames, *supra* note 1, at 511.

³⁵ Comment, *supra* note 34, at 221. But see Note, *Following Misappropriated Funds Into Life Insurance Policies*, 4 *ST. JOHN'S L. REV.* 239 (1930).

³⁶ As recently as 1967, a court has used tracing woodenly to reach such a result. See *Baxter House, Inc. v. Rosen*, 27 A.D.2d 258, 278 N.Y.S.2d 442 (1967).

³⁷ See, e.g., 1 G. PALMER, *supra* note 1, § 2.15(b), at 190-91. The Yale Comment set forth the argument as follows:

The defrauded person's recovery of the increased value of the trust *res* in cases of constructive trusts has been aptly termed a "windfall", and in the case of ordinary investment of trust property there seems to be no reason why he should not get it in the absence of a better claim. But since in life insurance, the increase over the misappropriated funds invested as premiums would go

tween an innocent beneficiary and an errant trustee but between two classes of innocent parties. Accordingly, tracing as an equitable remedy should be modified as justice requires.³⁸

This argument on the equities can be expanded easily to cases in which unlimited tracing would allow a plaintiff to claim against innocent third parties who hold traceable property.³⁹ Corollaries of the basic argument extend to still other types of cases, such as those involving the rights of creditors of the defendant. For example, suppose that a trustee wrongfully exchanges the trust res, Blackacre, for personal title to Whiteacre. Later, he mortgages Whiteacre to a third party and squanders the mortgage proceeds. The trustee has no assets other than Whiteacre. The beneficiary prevails by invoking tracing doctrine to claim Whiteacre free of the third party's mortgage interest, arguing that the third party is a constructive trustee. Courts, through tracing, give the beneficiary an implied ownership interest in Whiteacre, and a mortgage is subject to superior ownership interests held by those who have not consented to the mortgage. If the beneficiary could claim only a money judgment for the value of Blackacre, his claim would be inferior to that of the third party's; the beneficiary would only have a claim for

to a person who gives nothing in return for it, it is suggested that his claim has not as great equitable strength as that of the dependent beneficiary. Moreover, in many cases the investment of part of the stolen money in insurance lulls the dependents into a feeling of security, and prevents them from taking out other insurance in some legitimate way. At any rate, to give this "wind-fall" to the defrauded person without giving adequate consideration to the functional aspects of life insurance is to fail to evaluate the situation properly.

Comment, *supra* note 34, at 227 (citations omitted).

³⁸ See, e.g., 1 G. PALMER, *supra* note 1, § 2.14(c), at 183 ("[T]his proprietary interest is created by equity and should be adapted so as to achieve equity.").

³⁹ The Restatement of Restitution limits tracing relief against "innocent converters" and "gratuitous transferees." See RESTATEMENT OF RESTITUTION §§ 203, 204 (1936). These rules are among the most difficult to follow in the *Restatement*. "Innocent converters" are individuals who unknowingly receive the equivalent of stolen property—property without title. Assume that an innocent converter exchanges the property for substitute property before receiving notice that he has no title to the original property. The owner of the converted property may then elect to sue for an equitable lien on the substitute property equal to the value of the converted property at the time of the conversion or at the time of its exchange by the innocent converter, unless the converter's skill has increased the value. *Id.* § 203. "Gratuitous transferees," on the other hand, are individuals who receive legal title to property subject to unknown equitable claims without paying value, as in the case of property obtained by the fraud of the donor. If a gratuitous transferee exchanges the property for substitute property before notice of the wrong, when sued by the wronged owner he may either surrender the substitute property, or submit to an equitable lien on the substitute property equal to the value of the property he originally received. *Id.* § 204. Several questions arise. Why, *after* the exchange has been made, are the gratuitous transferees treated differently from innocent converters? At that time, both hold legal title to the substitute property subject to equitable claims. Moreover, why do both provisions seem to distinguish between an increase in value of the traceable property and "profit" resulting from the defendant's skill in obtaining an advantage on resale? See RESTATEMENT OF RESTITUTION § 154 comment a; *id.* § 204 comment d (1936). The decision to hold the property may involve as much skill in assessing the market as the decision to sell or exchange.

the residue of the proceeds, if any, after the third party's mortgage interest had been satisfied. Thus, the beneficiary's tracing right in effect accords him an ownership interest that vests him with priority over the mortgage holder. In the abstract, some find this result to be fair; the beneficiary should prevail because he was an innocent victim of the trustee's misappropriation and the third party mortgagee could have protected himself with reasonable inquiries and insurance. Indeed, it may be said that the third party contractually assumed the risk of the trustee's defective title. There is disagreement on this point, however.

One court recently refused to use tracing to allow a tort victim priority over the wrongdoer's secured creditors. The Colorado Court of Appeals, in an unusual decision, *Department of Natural Resources v. Benjamin*,⁴⁰ refused to grant a claimant tracing relief when it would have disadvantaged secured creditors. Mr. Benjamin, a sporting-goods store owner, embezzled the proceeds of game- and fishing-license sales, using the proceeds to pay personal and business expenses and to purchase inventory. On a tracing theory, the state seized the inventory in pre-judgment proceedings, and a bank, holding a security interest in the inventory, intervened. The trial court accorded priority to the bank's claim. The court of appeals affirmed on alternative grounds, one of which dealt with the theory of tracing relief:

Finally, the [state] misinterprets the theory of imposing a constructive trust, or equitable lien, on property wrongfully taken as being a right to which it is entitled regardless of the relationship of the other parties in the case. A court may impose a constructive trust where its only effect is to return property to a plaintiff but may deny it on the same basic facts where its effect would be to work an unwarranted preference over general creditors. . . . In the present case, the imposition of a constructive trust is especially inappropriate because the bank is not merely a general creditor, but holds a perfected security interest in the property claimed.⁴¹

Even if one believes that tracing should be used to prefer the claims of innocent victims over the claims of secured creditors or mortgagees against a wrongdoer's assets, one finds the equities in favor of tracing relief strained when Whiteacre is significantly more valuable than Blackacre. Should the beneficiary take all, at a significant personal profit, while the third party mortgagee takes nothing? Suppose that Whiteacre is now valuable enough both to satisfy completely the third party's mortgagee interest and to make the beneficiary whole by restoring the lost value of Blackacre. Traditional enthusiasts of tracing would rely on a simple deduction from the "necessities" of equitable owner-

⁴⁰ 41 Colo. App. 520, 587 P.2d 1207 (1978).

⁴¹ *Id.* at 532, 587 P.2d at 1209 (citation omitted).

ship, and hold that the beneficiary takes all.⁴² Modern commentators, however, would limit the beneficiary's recovery to his actual loss.⁴³ The conflict, again, is not between an errant trustee and an innocent beneficiary, but between two innocent parties. Here, to the extent that the beneficiary receives more than the lost value of Blackacre, the *beneficiary* profits at the third party mortgagee's expense, not at the expense of the trustee. Therefore, the revisionists conclude, the beneficiary should recover appreciated assets *in specie* only if there are no other innocent parties with a claim to the property.

Another class of controversial cases involves those in which tracing enables a claimant to reach assets exempt from general creditors.⁴⁴ Traditionalists would allow the victim to claim all traceable property *in specie* even when it is otherwise exempt from claimants.⁴⁵ The revisionists, on the other hand, would at minimum limit tracing to an equitable lien on the exempt assets for the amount of the victim's actual loss.⁴⁶

Observe that in all the foregoing cases but *Benjamin*, the revisionists still favor the use of the principle of equitable ownership to define the core of tracing doctrine. For example, in the life insurance case modern commentators agree that the beneficiary should have *some* claim on the life insurance proceeds; they focus on how to measure that claim. But the fact that the beneficiary has *any* claim on the proceeds *in specie* is a product of the direct-exchange rule that originated in trustee-miscon-

⁴² See RESTATEMENT OF RESTITUTION § 202 comments e, f (1936).

⁴³ 1 G. PALMER, *supra* note 1, § 2.14(c) ("[I]t is significant that almost as a matter of course the decree in favor of the claimant against an insolvent estate goes no further than to impress a lien on the traced asset."). See D. DOBBS, *supra* note 1, at 244-45; see also Republic Supply Co. v. Richfield Oil Co., 79 F.2d 375 (9th Cir. 1935); *In re* J.M. Acheson Co., 170 F.427 (9th Cir. 1909); Smith v. Township of Au Gres, 150 F.257 (6th Cir. 1906).

⁴⁴ All states, by constitution or by statute, restrict creditor recourse to certain property. These statutes are designed to protect the debtor from himself, shelter the debtor's family from the debtor's excesses, and minimize society's burden of providing for the debtor and his family by preserving his opportunity for self-support. See Haskins, *Homestead Exemptions*, 63 HARV. L. REV. 1289, 1289-91 (1950).

The laws are old and varied. Most states exempt a small amount of personal property (by value or by type), life insurance proceeds, some amount of wages, and an interest in the family income. See, e.g., MICH. CONST. art. 10, § 3; TENN. CONST. art. 11, § 11 (1977); KY. REV. STAT. § 427.010(1) (1979); N.Y. CIV. PRAC. LAW § 5206 (McKinney 1978 & Supp. 1983); VA. CODE §§ 34-4 to 34-31 (Supp. 1982). The protection is not absolute. A federal tax lien may be satisfied from some exempt property. See, e.g., I.R.C. § 6334 (1976); KY. REV. STAT. § 427.010(3)(c) (1979); N.Y. CIV. PRAC. LAW § 5206(a) (McKinney Supp. 1981); OHIO REV. CODE ANN. § 5719.08 (Page 1980). Many states also carve exceptions for state taxes, alimony, and child-support obligations. See, e.g., CONN. GEN. STATS. § 52-352b(h) (1981) (child support); DEL. CODE ANN. tit. 10, § 4910 (1974) (state taxes); N.Y. CIV. PRAC. LAW § 5205(d)(3) (McKinney 1978) (alimony). Most states allow mortgages and security interests to be foreclosed despite the exempt-property statutes. E.g., KY. REV. STAT. § 427.060 (1979); N.Y. CIV. PRAC. LAW § 5206(a) (McKinney Supp. 1981).

⁴⁵ See RESTATEMENT OF RESTITUTION § 202 comment k (1936); 5 A. SCOTT, *supra* note 1, § 508.3.

⁴⁶ See 1 G. PALMER, *supra* note 1, § 2.15, at 187.

duct cases.⁴⁷ Thus, although modern commentators often scorn equitable ownership as a controlling theory in tracing cases, they do not ultimately repudiate the concept. Instead, they invoke considerations of fairness to readjust the results where obvious inequities arise. But if I am right, a more radical course is appropriate.

Even if courts adopt the position of modern commentators and revise tracing doctrine in select cases to adjust for the inequities that rigid application of the equitable ownership concept produces, the doctrine will continue to be fundamentally defective. Tracing doctrine applied in this form overcalculates the extent of the defendant's benefit and creates arbitrary distinctions among claimants and among defendants, distinctions that do not correspond to the actual facts of the cases. These defects are the subject of the succeeding sections.

III

TRACING AND MEASUREMENT OF THE DEFENDANT'S BENEFIT

Courts have had great difficulty in applying tracing doctrine when a defendant demands: (a) reimbursement of the value of personal time, money, or property that he contributed in maintaining, improving or creating the traceable property; and (b) apportionment of any gain created by his expenditures in combination with the traceable property. Courts make conflicting responses to these contentions.⁴⁸ For example,

⁴⁷ See *supra* note 30 and accompanying text.

⁴⁸ Courts facing reimbursement and apportionment questions in tracing looked initially for guidance to the rules developed in the context of breached trusts. In dealing with disobedient trustees holding trust res for their own account, the courts hold that the trustee is entitled to reimbursement for expenditures incurred on the misappropriated property only if he clearly would have made similar expenditures out of the trust res had he acted properly and on behalf of the beneficiary. Presumably, if a trustee, while wrongfully pursuing his own interests, decides that expenditures are necessary, he would have made the same decision had he continued to manage the property for the beneficiary. Because repairs and payment of encumbrances are routine necessities in conscientious trust administration, but improvements are not, courts usually give credit for the former, but not the latter. Compare *Tegtmeyer v. Tegtmeyer*, 314 Ill. App. 16, 40 N.E.2d 767 (1942) (guarantor in action for accounting of proceeds from sale of trust property entitled to credits for taxes and special assessments paid to obtain guaranty policy for property) and *Hawley v. Tesch*, 88 Wis. 213, 59 N.W. 670 (1894) (fraudulent purchaser of trust property credited with amounts paid for taxes, commissions to agents, and costs of title abstracts) with *Bolton v. Stillwagon*, 410 Pa. 618, 190 A.2d 105 (1963) (trustees who violated duties deserve no reimbursement for improvements made upon property) and *Cawthon v. Cochell*, 121 S.W.2d 414 (Tex. Civ. App. 1938) (agent has no right to repayment for value of improvements to trust property). The size of the credit is the lesser of the amount actually spent or the increase in value of the property caused by the expenditure. See, e.g., *Morse v. Hill*, 136 Mass. 60 (1883); see 4 A. SCOTT, *supra* note 1, at § 291.6. Even if the trustee receives credit for expenditures, however, he may not claim any portion of the appreciation caused by those expenditures. Had the trustee acted properly—holding the property for the trust account and making the expenditures out of trust res—the trust would have received the benefit of the entire gain. See, e.g., *Lang v. Girardo*, 311 Mass. 132, 40 N.E.2d 707 (1942); *Morse v. Hill*, 136 Mass. 60 (1883). Some courts fashioned an important

if Wrongdoer steals a teapot from Owner-One and exchanges it, plus \$50 cash, for a guitar worth \$150, some courts allow Owner-One to claim, through a constructive trust, a two-third ownership interest in the guitar.⁴⁹ On the other hand, in some jurisdictions, if Wrongdoer expends the equivalent of \$50 in time repairing the dents in the teapot so that he can exchange it without more for the guitar worth \$150, some

exception for expenditures of personal time: If an errant trustee spends valuable personal time augmenting the value of wrongfully taken trust res, he will not receive credit for the value of his time, even if it was time that he would have expended had he acted properly. Moreover, the errant trustee must remit any payment received for his services during the period of his wrongful actions. *See generally* Callaghan v. Myers, 128 U.S. 617, 663-64 (1888). The courts base the exception on a refusal to pay "salaries to wrongdoers."

If the trustee wrongfully exchanges the trust res for substitute property and incurs expenses in acquiring or maintaining the substitute property, the analysis of the courts in determining the trustee's rights to reimbursement moves toward the limits of sensible speculation. Although the exchange is wrongful, courts assume the substitute property to be in the trust—a fiction of regularity—and continue to ask whether the trustee would have made the expenditures on the property had he acted properly. For example, Wrongdoer, trustee of a stock portfolio, wrongfully exchanges some of the stock for a personal yacht and incurs expenses in maintaining it. The court will ask whether, assuming the yacht to be in the trust, the trustee would have incurred such maintenance expenses had he held the yacht on behalf of the beneficiary. Hampering the inquiry, of course, is the difficulty in speculating on circumstances that are based on the counterfactual assumption that the trust would have contained the yacht.

Moreover, the nature of the fiction seems to change when the size of the wrongdoer's personal expenditures is large in comparison with the amount of the trust res wrongfully appropriated. Wrongdoer, a trustee of a stock portfolio, wrongfully exchanges \$100 worth of the trust stock and \$100 of his own funds for a \$200 mink coat that appreciates in value to \$240. The beneficiary's equitable interest in the coat is routinely limited to one-half of its value, \$120. *See* RESTATEMENT OF RESTITUTION § 210(2) & comment d (1936). In determining whether to grant a credit for the \$100 personal expenditure, courts do not ask whether the trustee, assuming that the exchange of stock for the coat was proper, would have (or should have) withdrawn the full \$200 from trust assets to buy the coat. Rather, courts assume that the beneficiary and the trustee have a joint interest in the property; the beneficiary maintains an equitable interest in one-half of the coat, and the trustee has a personal legal interest in the other one-half. The fiction, therefore, shifts from one artificial assumption in expense cases, that the trustee was properly managing the res when he made the exchange—to another in the joint-fund cases, that the trustee and the beneficiary have agreed to a partnership of sorts in the newly acquired property. The shift has significant results for the errant trustee: In the former case he may receive his personal expenditures; in the latter case he is entitled to not only his expenditures, but also to a portion of the profit attributable to those expenditures. Although the courts have not analyzed the line of demarcation, apparently the shift turns on the magnitude of the trustee's personal expenditure. The larger the expenditure in relation to the value of the misappropriated trust res, the more likely that courts will consider the trustee a joint owner of the traced property.

With the extension of the constructive trust and tracing remedies to all cases involving fiduciary breaches, the rules from the trust cases can no longer be sensibly applied. In cases of fiduciary conversion in which the defendant has no legitimate management responsibilities (he is a simple bailee, for example), it is pure folly to ask the court to speculate on whether the defendant would have made the expenditures if he had possessed management responsibilities over the traceable property and was carrying them out reasonably. The artificial fictions are nonsensical and the courts must focus simply on the core notion of what are reasonable results under the circumstances. Cohesive guidelines have yet to emerge in the case law.

⁴⁹ *See, e.g.,* Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390 (1939).

courts allow Owner-One to claim the guitar.⁵⁰ Less clear is whether Owner-One may claim the guitar without paying Wrongdoer \$50, if Wrongdoer has paid \$50 to a dent-repair specialist before he exchanges the teapot for the guitar.⁵¹ In all three cases, Wrongdoer's financial position is essentially identical: He has parted with a \$100 teapot and \$50—or its equivalent in personal time—in exchange for a guitar worth \$150.

The disparity of treatment in each of the three foregoing kinds of cases increases if Wrongdoer realizes a profit. If the guitar is worth \$200, and Owner-One makes no claim, Wrongdoer has a \$50 profit in each case. Yet Owner-One's claim varies from case to case: in the first case, Owner-One can claim two-thirds of a guitar worth \$200, a value of \$133; in the second case, Owner-One receives an undivided interest in the guitar, a value worth \$200; and in the third case, Wrongdoer receives a credit of \$50, and Owner-One receives \$150 in value. Thus, in the first case the profit is apportioned and Wrongdoer receives a \$17 profit in addition to a credit for his \$50 contribution to the price of the guitar. In the second case, Wrongdoer is penalized to the extent of the value of his personal services and denied any part of the profit, even though he risked the value of his time. In the third case, Wrongdoer may be reimbursed for his expenses, but probably will not receive any of the profit even though he has risked his \$50.

The distinctions created by courts in this area are a product of the historical legacy of tracing that attaches consequences based on physical rather than causal events. Moreover, the distinctions may also be influenced by latent factual assumptions: for example, paying Wrongdoer a salary for repairing dents in a teapot which he stole is apparently harder to stomach than crediting him for paying to have the dents repaired because it is likely, perhaps, that the Wrongdoer would not have re-

⁵⁰ See, e.g., *Callaghan v. Meyers*, 128 U.S. 617, 663-64 (1888); cf. *Olwell v. Nye & Nissen Co.*, 26 Wash. 2d 282, 173 P.2d 652 (1946), discussed in *Oesterle*, *supra* note 9, at 354. But see *Brooks v. Conston*, 364 Pa. 256, 72 A.2d 75 (1950).

⁵¹ The *Restatement* and Professor Scott would distinguish between ignorant and conscious wrongdoers. See *RESTATEMENT OF RESTITUTION* § 158 (1936); 5 A. SCOTT, *supra* note 1, § 479.1. A conscious wrongdoer can be reimbursed for the discharge of liens, the payment of taxes, and necessary repairs or maintenance, unless it would work a "hardship" on the victim. He cannot obtain reimbursement for unnecessary repairs, improvements, or additions. See *RESTATEMENT OF RESTITUTION* § 158 (1936). Ignorant wrongdoers are entitled to all expenditures for repairs, even those that exceed their reasonable value, unless it would work a hardship for the victim; the victim's argument, that he would have not incurred the expenses himself had there been no wrongful taking, is unsuccessful. No case law appears to either explicitly follow the distinction or explicitly reject it; the issue seems to have escaped serious judicial consideration. Moreover, neither the *Restatement* nor Professor Scott makes clear whether a disobedient trustee can ever be "innocent," and thus benefit from the rule, or whether the rule is restricted to third parties acting without knowledge of the trustee's breach. In another context, however, the *Restatement* equates all fiduciaries who are guilty of breaches of trust with conscious wrongdoers. See *RESTATEMENT OF RESTITUTION* § 202 (1936); *id.* comments a, b.

ceived \$50 for his services had he not stolen the teapot. He surely could have used elsewhere the \$50 that he spent on the dent specialists. Whatever the cause, at present the courts' explanations of the distinctions seem remarkably unsophisticated. Indeed, the distinctions mask a far more significant problem; deficiencies in the definition of benefit that is an integral part of the concept of unjust enrichment.

A. Benefit Received as Saved Cost: General Rule and Exceptions

Assume that Wrongdoer, with ten dollars in his pocket, steals ten dollars from Owner. Wrongdoer then deposits his ten dollars in an interest-bearing bank account and exchanges Owner's ten dollars for a hat. At the time Owner gets a judgment against Wrongdoer, the bank account has produced one dollar of interest and the hat is worth fifteen dollars. Owner traces into the hat and realizes a profit of five dollars from his stolen money. Tracing conclusively presumes that Wrongdoer's benefit from the conversion is the traceable product—the hat. Wrongdoer argues that his real benefit from the conversion is not fifteen dollars but eleven dollars, for had he not stolen Owner's money, Wrongdoer would have purchased the hat with his ten dollars and foregone the one dollar of interest. His profit from the conversion, Wrongdoer contends, was the money stolen, plus the one dollar of interest that he was able to earn as a result of depositing his own ten dollars with a bank at market rates of interest. Alternatively, he argues, if he had not used Owner's ten dollars to buy the hat, he would have borrowed ten dollars at a certain rate of interest (assume that the interest totaled one dollar) in order to buy the hat. Therefore, his benefit from stealing Owner's ten dollars is the debt of ten dollars plus one dollar of interest otherwise necessary to buy the hat. Again, Wrongdoer asserts that his actual gain from the conversion is eleven dollars, not the fifteen dollars claimed by Owner.

Objectively, the wealth that Wrongdoer gained as the result of the conversion depends on whether he still would have bought the hat had he not taken Owner's money. If so, then the actual benefits arising from the misappropriation are measured more accurately by the difference between Wrongdoer's wealth after the misappropriation and Wrongdoer's wealth had he purchased the misappropriated property with available funds or lines of credit. Wrongdoer's actual benefit arising from the conversion is his ability to forego use of the other available sources of capital to purchase the hat. The four-dollar gain,⁵² representing what Wrongdoer would have realized if he had acted lawfully in purchasing the hat with his own ten dollars (or with a borrowed ten

⁵² The dollar gain is the value of the hat (\$15), minus the \$10 purchase price and the otherwise-available one dollar of interest on the \$10.

dollars) is not a benefit derived from the conversion; rather, the benefit is attributable to extraneous factors, such as smart trading, or favorable market conditions. On the other hand, if Wrongdoer would not have bought the hat without Owner's money, then he can be said to have the hat solely as the result of the conversion. Even so, the calculation of Wrongdoer's benefit is not as simple as tracing implies, as subsection B will shortly illustrate.

Of course, whether Wrongdoer would have bought the hat had he not misappropriated Owner's money is a factual inquiry requiring conjecture on Wrongdoer's conduct in a context that assumes no intentional conversion. Tracing cuts off such an inquiry by conclusively presuming that Wrongdoer would not have acquired the hat absent the conversion. In cases in which Wrongdoer has available funds or borrowing capacity that far exceeds the value of the conversion or the traceable property, however, the presumption is irrational. Why should one assume that Wrongdoer would take advantage of a "deal"—buying a fifteen dollar hat for only ten dollars—solely because he had converted ten dollars of Owner's funds? The more plausible assumption is the reverse: Even without Owner's ten dollars, Wrongdoer would have taken advantage of the "deal" by using his own funds or his borrowing capacity.

Tracing, in other words, should be rejected as a measure of benefit in those cases in which the Wrongdoer's financial condition renders plausible his claim that he would have bought the traceable asset absent the misappropriation. A calculation of benefit in such cases should instead consist of the value of the misappropriation at the time of its occurrence, plus the interest on that value at the rate available to Wrongdoer either on other funds or the rate available if he had borrowed a sum equivalent to that value. Documentation of the Wrongdoer's various exchanges in order to trace into the product of the misappropriated product would be unnecessary. Rather, the court's inquiry would focus on the interest rate that Wrongdoer would have received in either depositing or loaning money, or the rate that he would have been charged in borrowing money.

One significant exception exists, however. Using tracing to measure a wrongdoer's benefit when his funds or borrowing capacity greatly exceeds the value of the traceable property appears justifiable in the case of a disobedient trustee (or a similarly situated fiduciary) who has the power and responsibility to manage the trust res by changing its form; ironically, this is the situation from which the tracing doctrine originally evolved.⁵³ When the trustee misappropriates property and uses it in transactions for his own account, he has misappropriated not only the property, but also his investment services. Consistent with the

⁵³ Tracing is similarly useful when corporate executives steal and use corporate property to take corporate opportunities.

analysis above, the trustee's benefit from the misappropriation of the res property is the value of the misappropriation and his saved interest. The trustee's benefit gained through withholding his services from the trust, however, is the value of those services that he was free to use for his own account. Therefore, an accurate measure of the value of his services is arguably their actual product: any appreciation or profit in, or income from, exchanges of the misappropriated res. Thus tracing serves as a measure of the *combined* benefit Wrongdoer acquires from the misappropriated property *and* from the withholding of his services. Yet, as the next subsection illustrates, whenever tracing is used in any context, against a fiduciary or insolvent wrongdoer, we are left with apportionment problems.

B. Credit and Apportionment for Wrongdoer's Contributions

The hard cases arise when the wrongdoer lacks the wealth or borrowing capacity to purchase the traceable property, or when the wrongdoer has sufficient funds, but the item is so expensive that he would not have bought it with merely his own funds. In such cases, the wrongdoer would not have acquired the traceable product of the misappropriated asset but for the conversion. Thus, the product of the misappropriated property may be an accurate measure of the wrongdoer's benefit at the plaintiff's expense; then again, it may not. If Wrongdoer contributes his own time or money to create or augment the value of the traceable product, the "but for" test is too simple: Wrongdoer may not have had the traceable product "but for" the misappropriation, but the traceable product that Owner claims may not have been so valuable "but for" Wrongdoer's efforts or contributions subsequent to the conversion. The issue has two parts: first, whether to *credit* Wrongdoer with expenses that he has incurred in the exchange of misappropriated property for traceable property; and if so, whether to *apportion* any profits gained through the exchange to those produced by Wrongdoer's expenditures. The inquiry is both theoretically and factually complex, and current tracing doctrine does not provide workable answers in this area.

Some modern writers retreat from the credit and apportionment problems by arguing that the courts should do whatever is fair under the circumstances.⁵⁴ Perhaps this is all that can be said. If, however, one demands more precision, the issue might be resolved as follows, consistent with the definition of benefit noted above (*i.e.*, tracing is limited to cases against select fiduciaries or essentially insolvent defendants). Conscious wrongdoers in the latter category should receive none of the gain generated by the misappropriation over and above a credit for their actual expenditures. Because such defendants could not have ac-

⁵⁴ See RESTATEMENT OF RESTITUTION § 158 (1936); 1 G. PALMER, *supra* note 1, at 161.

quired the gain absent the wrongdoing—they had no substitute source of cash—they should not receive an apportionment of the profits. They should, however, receive credit for the actual value of any expenditures of time and money to the extent that such expenditures augmented the value of the traceable items. On the other hand, defendants ignorant of their wrong, but nonetheless legally culpable, should always receive an apportionment of the profits as well as credit for their expenditures.⁵⁵

For example, Wrongdoer steals a teapot from Owner worth \$100. Wrongdoer pays \$10 dollars to repair the teapot and exchanges the teapot for a guitar worth \$200. Wrongdoer has no other assets, either at the time of the theft or at the time of the exchange. His gain from the theft is \$190. Because without the theft he had no source of capital to

⁵⁵ The *Restatement* reflects this distinction by finding that innocent converters and gratuitous donees are entitled to profits resulting from their skill in using the traceable property, but that tortious converters must surrender all profits from the use of the property. RESTATEMENT OF RESTITUTION § 202-204 (1936).

Professor Dawson recently argued, in the context of the restitutionary claim for an accounting of profits, that the conscious-unconscious distinction has been justifiably rejected by American courts. See Dawson, *supra* note 8, at 619. His observation seems to rest on the fact that few cases invoke the distinction and that many of the cases involving fiduciary breaches implicitly reject the distinction. His argument that the distinction itself should be rejected seems to rest on his view that it “presuppose[s] that this is punishment for moral fault.” *Id.* at 617. But see RESTATEMENT OF RESTITUTION § 202 comment c, § 203 comment a (1936) (conscious-unconscious rule is shorthand for a distinction between cases in which deterrence is necessary and those in which it is unnecessary).

Professor Dawson argues that the decision to divest the defendant of profits should rest first, on an assessment of whether the remedy is necessary to deter the conduct in issue, and second, on whether the “gain is illegitimate” as the result of “invading immunities of another to which the legal order had determined to give full-scale protection.” Dawson, *supra* note 8, at 617. He also seems to place primary importance on the second factor: “[P]olicing . . . is not the main object of restitution. Accounting for profit will be awarded, if it is, because it has been shown and to the extent it is shown that the interest invaded contributed to producing the profit.” *Id.* at 620. Dawson offers one caveat to his position, however: “It may be that where the restitution claim becomes attenuated and the gain must be traced from its original form into an identified product, the one who was ‘unconscious’ of any wrongdoing should not have to account for additional profit through favorable investment.” *Id.* at 619 (footnote omitted). In the caveat, of course, he seems to favor the conscious-unconscious distinction peculiarly in tracing. His comment is somewhat puzzling. Is the issue a matter of proof? Are unconscious wrongdoers allowed the benefit of a higher standard of proof on whether the profits were the result of the wrong? Or is the issue the preservation of the unconscious wrongdoer’s right to benefit from his skills in making the profits?

The conscious-unconscious distinction seems justified because of the sterility of a “but for” causation test. “But for” the wrong, neither the conscious nor the ignorant wrongdoer would profit in cases in which tracing may accurately measure benefit. The same can be said for their personal contributions; neither wrongdoer would profit but for his personal contributions. We should refuse to apportion the profit in the case of the conscious wrongdoer, but should allow it in the other case of the ignorant wrongdoer, because of the character of the wrong. The balance between the policies of encouraging productive use of property and deterring wrongful conduct is different in the two cases; in the case of the conscious wrongdoer the latter policy prevails, while in the case of the ignorant wrongdoer the former policy is stronger. Reckless conduct poses a harder case. See RESTATEMENT OF RESTITUTION § 202 comment a Caveat (1926); *id.* § 203 Caveat (1936).

buy the guitar (and assuming no sharp trading), his entire gain is a result of the theft. Therefore, as a conscious wrongdoer, Wrongdoer should not receive a portion of the profits equal to the percentage of his legitimate contribution (\$10) to the deal. Yet, he should be able to claim a credit for his \$10 expenditure if it increased the value of the teapot by \$10 or more. Refusing to grant the credit would not further any policy of disgorging Wrongdoer's benefit; refusal would simply penalize him in the amount of his expenditure and give the penalty to the plaintiff as a windfall.⁵⁶ Because restitution does not purport to penalize, its underlying rationale cannot support a denial of the credit.

Moreover, a penalty in one context is no less a penalty in another. If, instead of spending ten dollars to fix the dents in the teapot, Wrongdoer spends ten dollars of time to fix the dents himself, he should be credited nonetheless.⁵⁷ If Wrongdoer's time is worth little, however, he should receive no credit. Whether Wrongdoer is unjustly benefited by credit for his time spent in the wrongful exchanges turns on the fair market value of his services, not on the simplistic notion that wrongdoers should never receive a salary for their illegal acts.⁵⁸

The analysis is a bit different in the case of disobedient trustees or other fiduciaries, in which tracing is justified as a measure of the value of services withheld from the plaintiff. These wrongdoers should not receive credit for any expenditures of time that augment the traceable property beyond the compensation fixed in the fiduciary arrangement. They should, however, receive credit for expenditures of money or the like, but need not receive any apportionment of the profits which are rightfully due the claimant as a result of the pre-existing relationship.

C. If Not Unjust Enrichment, Deterrence?

At this point it is tempting to search for a reason other than the principle of unjust enrichment to justify traditional tracing relief. An obvious candidate is deterrence of misappropriations: Tracing relief, although often operating harshly by granting the plaintiff a windfall exceeding the real gain attributable to the defendant's misappropriation, is arguably needed to deter wrongdoing. Perhaps a penalty in addition to the disgorgement of any wrongfully acquired gain would serve as a stern warning to putative wrongdoers.

The deterrence theory, however, does not wash. First, it is not clear

⁵⁶ For one case in which this principle led to absurd results, see 319 East 72nd St. Corp. v. Warnecke & Co., 20 A.D.2d 513, 244 N.Y.S.2d 604 (1st Dep't), *appeal dismissed*, 13 N.Y.2d 1126, 196 N.E.2d 558, 247 N.Y.S.2d 126 (1963) (defendant may not set off the costs of improvement or receive credit for any portion of the increased value of a once-barren piece of land worth \$655,000 that defendant improved to the extent that it was worth \$3,675,000).

⁵⁷ See *Janigan v. Taylor*, 344 F.2d 781, 787 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

⁵⁸ See *supra* note 48.

that civil penalties are necessary if criminal penalties also apply. Second, it is arguable that the only real deterrence distinct to tracing is a warning to wrongdoers either to take care to obscure the transactional trail of misappropriated assets or to dissipate funds that are traceable to misappropriated items by investing them in food, vacations, and other perishables. For example, Wrongdoer converts an automobile and exchanges it for stock that he still holds. If the stock is equal or lesser in value than what the victim could recover in a simple money judgment, then, of course, tracing per se does not provide any additional deterrence over that attributable to the damages remedy. On the other hand, if the stock has significantly appreciated and is greater in value than what the victim could recover in a money judgment, then tracing, in forcing the Wrongdoer to disgorge the stock, exacts a greater penalty and can be said to create added deterrence against conversions. Calculating wrongdoers, however, could read the remedy as not deterring conversions but rather as deterring acts after conversion that support tracing—direct exchanges of the converted property for other property, for example. Thus, perhaps, tracing effects how knowledgeable wrongdoers use misappropriated property rather than the initial act of conversion itself.

Third, the size of the penalty is limited to events that may have little or no relationship to the considerations that should affect the imposition of such a penalty. In the example in the previous paragraph, the amount of appreciation of the stock determines the size of the penalty exacted. The transactional trail originating with the misappropriated item may cause the penalty to be relatively large or small. The trail, however, is independent of the opprobrium associated with the defendant's act and the amount of his net wealth—factors significant in an assessment of the size of any penalty that deters the unwanted conduct. In sum, if the creation of a penalty for certain acts is the goal, it makes little sense to hobble its calculation by the use of the tracing formula.

IV

TRACING'S ARBITRARY DISTINCTIONS BETWEEN CLAIMANTS

Tracing Doctrine also fails to identify satisfactorily *who* may claim the defendant's gain from the misappropriation. Consider the following hypothetical case:

Wrongdoer converts two silver teapots, each valued at \$100 and owned by Owner-One and Owner-Two respectively. Wrongdoer exchanges Owner-One's teapot for a guitar and Owner-Two's teapot for wine, which Wrongdoer consumes. When Wrongdoer is caught, Owner-One and Owner-Two find that Wrongdoer's only asset is the guitar, and they both sue Wrongdoer. Because Owner-One can trace

his teapot into the guitar, he can charge Wrongdoer as a constructive trustee of the guitar, or enforce an equitable lien on the guitar for \$100. Owner-Two, however, cannot trace his teapot into the guitar, and thus can receive only a money judgment against Wrongdoer for \$100. Owner-One, if prompt, therefore recovers all of Wrongdoer's tangible assets, and Owner-Two recovers nothing.

The primacy of a transactional link over a causal link in the law of tracing grants Owner-One a preferential recovery. Owner-One can reconstruct a line of physical exchanges beginning with his teapot, but Owner-Two cannot.⁵⁹ This result is unaltered if Owner-Two can prove that had Wrongdoer converted only one teapot, he would have exchanged it for wine and, therefore, that the conversion of *both* teapots was essential to Wrongdoer's exchange of one teapot for a guitar. Similarly, the result is unaltered if Owner-Two proves that Wrongdoer did not care which teapot was exchanged for the guitar, or even that Wrongdoer flipped a coin to determine which teapot was so exchanged. Although Wrongdoer's relationship to Owner-One and Owner-Two is essentially indistinguishable, Owner-One ends up better off under standard tracing doctrine than Owner-Two because his teapot happened to be exchanged for the guitar, a fortuity that occurred after the conversion of both teapots.

In the law of tracing, this historic rule of preference for Owner-One is based on the assumption that Wrongdoer has the guitar solely because he misappropriated Owner-One's teapot, and that the guitar represents his gain wrongfully acquired from this conversion alone. Yet, as the above hypothetical demonstrates, this assumption may be false. Where the assumption is false the better result, that Owner-One and Owner-Two split the value of the guitar, is thwarted by tracing doctrine. Moreover, the demands of judicial convenience do not justify the sacrifice of Owner-Two's claim. Admittedly, Owner-Two may have difficulty proving that the conversion of his teapot was essential to the Wrongdoer's acquisition of the guitar.⁶⁰ Nonetheless, a case can be made that even where the facts are unknown, there should be a presumption that the teapots of *both* Owner-One and Owner-Two, if stolen within a fixed pe-

⁵⁹ Similar disparate treatment of Owner-One and Owner-Two occurs when Wrongdoer is a fiduciary with responsibilities for managing the misappropriated property. Thus, Wrongdoer takes Owner-One's and Owner-Two's property. He reinvests Owner-One's property at a profit, but exchanges Owner-Two's property for wine that he consumes, freeing Wrongdoer's other assets for reinvestment at a profit. Tracing presumes that Wrongdoer profited at the expense of Owner-One but not at the expense of Owner-Two.

⁶⁰ The court would need to reconstruct the defendant's reasons for exchanging the teapots for substitute property: Was the acquisition of both teapots necessary to enable him to acquire the guitar? The evidence would be subjective and the defendant's credibility suspect. Moreover, the defendant may not have thought about his acts in such a manner at the time he undertook them. In sum, asking the defendant for a self-analysis of earlier motives may be an extremely speculative and untrustworthy enterprise.

riod of the Wrongdoer's acquisition of the guitar, enabled Wrongdoer to acquire the guitar. If the guitar is worth more than both teapots, Owner-One and Owner-Two would enjoy a division of the gain. This presumption has the advantages over tracing of erring in favor of, rather than against, Owner-Two on the facts, and of preserving a minimal claim for Owner-One.

The inequity of treatment between Owner-One and Owner-Two appears particularly harsh when the guitar at the time of judgment is worth \$150—a sum sufficient to satisfy fully the loss of Owner-One and still leave \$50 for Owner-Two. Prevailing doctrine, however, indicates that even then Owner-One can claim the guitar *in specie*. Some argue that Owner-One should be limited in this case to an equitable lien equal to his actual loss: Owner-One would collect \$100 and Owner-Two would collect \$50.⁶¹ Even if this result is accepted, however, the essential inequity of the previous situation persists, for Owner-Two is left with a smaller recovery than Owner-One. Moreover, the results allow Owner-One what is in effect, a secured claim; that is, Owner-One has an *in specie* claim on the guitar through constructive trust, while Owner-Two has only a money judgment.

The lesson of the illustration extends beyond those few cases in which Wrongdoer is subject to the claims of more than one victim. Once one recognizes that Owner-One and Owner-Two may not deserve disparate treatment, one must acknowledge that the inequity is similar if *distinct wrongdoers* victimize Owner-One and Owner-Two. Assume that Wrongdoer-One, with \$100 in his pocket, converts Owner-One's teapot worth \$100 and exchanges it for a guitar. Wrongdoer-One exchanges the \$100 in his pocket for wine, which he consumes. Owner-One can claim the guitar under tracing doctrine. Wrongdoer-Two, who also has \$100 in his pocket, converts Owner-Two's teapot and exchanges it for \$100 worth of wine, which he consumes. Wrongdoer-Two exchanges the \$100 that was in his pocket for a guitar. Owner-Two proves that had Wrongdoer-Two not been able to convert Owner-Two's teapot, he would have spent the \$100 in his pocket on wine. Owner-Two cannot trace; he may only obtain a personal judgment against Wrongdoer-Two for \$100 and attempt to execute on the guitar—a far less powerful remedy. Tracing, in contrast, assumes that Wrongdoer-One possesses the guitar solely because of the conversion of Owner-One's teapot, and therefore forces Wrongdoer-One to turn the guitar over to Owner-One as a way of stripping Wrongdoer-One of any benefit from the wrong. Yet, on the facts above, Owner-One's rights against Wrongdoer-One logically should be no better than Owner-Two's rights against Wrong-

⁶¹ See *supra* text at notes 34-47.

doer-Two; both Wrongdoer-One and Wrongdoer-Two have a guitar as a direct result of their conversions.

The more sensible approach might be to allow Owner-Two to prove, if possible, that the theft of his teapot enabled Wrongdoer-Two to free up and use other funds or assets to purchase the guitar. Again, however, the relevant facts may be very difficult to determine.⁶² Still courts could assume that Wrongdoer-Two has gained at Owner-Two's expense, if Wrongdoer-Two acquires assets within a fixed period after the conversion—rather than assume as tracing does, that he has not gained in any way at Owner-Two's expense.⁶³ Thus Owner-Two, whose \$100 teapot was converted, could claim Wrongdoer-Two's guitar even if it is worth over \$100,⁶⁴ simply because Wrongdoer-Two bought it for \$100 soon after the theft; the exchange of the teapot for now-consumed wine becomes irrelevant. One assumption seems no less arbitrary on the facts than the other and, again, this presumption has the advantage of erring in favor of Owner-Two (and conversely, against, rather than for, Wrongdoer-Two).

The arbitrariness of this disparate treatment extends to all cases in which Owner-One can trace but Owner-Two cannot. Thus, when Owner-One can claim appreciated property, exempt property, or a priority over other creditors,⁶⁵ he is unjustly favored over similarly situated parties who cannot trace. For example, assume that Wrongdoer-One, with \$100 in his pocket, converts Owner-One's \$100 teapot and exchanges it for a guitar worth \$150. He spends the \$100 in his pocket on wine, which he consumes. Owner-One claims the guitar through tracing, making a profit of \$50. Wrongdoer-Two, with \$100 in his pocket, converts Owner-Two's \$100 teapot. Wrongdoer-Two uses the cash in his pocket to buy, at a bargain price, a guitar worth \$150. He exchanges Owner-Two's teapot for \$100 in wine, which he consumes. Assume

⁶² See *supra* note 69.

⁶³ A version of this argument is found in Professor Gilmore's interpretation of U.C.C. § 9-306(4)(d)(ii). See G. GILMORE, *supra* note 28, § 45.9, at 1338-39; see also *infra* notes 81-83. Moreover, one could argue that such a presumption is inherent in the court's interpretation of § 17(a)(2), (4) [now § 523(a)(2), (4)] of the Bankruptcy Act in *In re Transport Clearings-Midwest, Inc.*, 16 Bankr. 890 (W.D. Mo. 1979). In that case, a shipper mistakenly paid money to the bankrupt instead of the plaintiff. The plaintiff argued that it was entitled to a constructive trust on the money even though it could not trace into an identifiable fund in the bankrupt's estate. The bankruptcy judge held that although the plaintiff had lost its right to reclamation it was nevertheless entitled to a decree of nondischargeability. The judge refused to leave the plaintiff on an equal footing with general unsecured creditors (whose claims were discharged), for "[s]uch a result offends the cardinal principle of equality that a person should not be allowed to benefit by his own wrong." *id.* at 893. The judge thus rejected the rule in *In re Whitlock*, 449 F. Supp. 1383 (W.D. Mo. 1978) that tracing is necessary to a decree of nondischargeability because the availability of tracing determines whether the bankrupt has in fact benefited or gained from the conversion.

⁶⁴ Of course, if other creditors are in the picture, other policies become important. See *infra* notes 69-75 and accompanying text.

⁶⁵ See *infra* text accompanying note 69.

Owner-Two can prove that Wrongdoer-Two would not have used his cash to buy the guitar had he not converted Owner-Two's teapot; Wrongdoer-Two's first priority was to obtain \$100 in wine. Nonetheless, Owner-Two can only obtain a money judgment against Wrongdoer-Two for \$100 and execute on the guitar. Tracing doctrine is premised on the notion that wrongdoers should be divested of any profit resulting from the wrong. Nonetheless, it allows only Owner-One to claim the \$50 profit, even though one can reasonably argue that, in the same sense, a \$50 profit resulted from the theft of Owner-Two's teapot. Tracing presumes that Wrongdoer-One's profit is causally linked to the wrong, but that Wrongdoer-Two's profit is not. Again, such conclusive presumptions may be contrary to fact.

The discussion thus far has focused on tracing exchange-products of misappropriated property, but the concerns raised also apply to the commingled-fund branch of tracing doctrine. Assume for example, Wrongdoer converts a dollar bill of both Owner-One and Owner-Two. Wrongdoer commingles Owner-One's dollar with Wrongdoer's other, indistinguishable dollar bills, but spends Owner-Two's dollar on wine, which he consumes. Owner-One can claim an equitable ownership interest in one of Wrongdoer's dollar bills, but Owner-Two is only a general creditor of Wrongdoer. Tracing doctrine thus holds that Wrongdoer's creditors should not benefit at the expense of Owner-One, and therefore in effect grants Owner-One a preference; the doctrine also conclusively presumes, however, that Wrongdoer's creditors do not benefit at the expense of Owner-Two, and this is true even though Owner-Two could prove that Wrongdoer would have spent one of his own dollar bills on wine had he not converted Owner-Two's dollar.

Moreover, it is difficult to justify any of the traditional tracing rules on withdrawals from a commingled fund as accurate calculations of Wrongdoer's actual benefit (and, therefore, of the benefit to Wrongdoer's other creditors) at the expense of Owner-One.⁶⁶ Each set of rules

⁶⁶ If the wrongdoer depletes the commingled fund, however, whose items are left? Early English cases applied a simplifying rule of first in, first out. *See, e.g.*, *Pennel v. Deffell*, 43 Eng. Rep. 551 (Ch. 1853); *Bronn v. Adams*, 4 L.R.-Ch. 764 (Ch. App. 1869). Thus, the rights of the parties depended on whether the wrongdoer first deposited his own items or those of the victim into the pool. In 1879, *Jessel, M.R.*, developed the modern view, now known as the Rule of *Jessel's Bag*. *See In re Hallett's Estate*, 13 Ch. D. 696 (1879). Under this view, the court presumes that the items withdrawn first are those of the wrongdoer. Thus, if a defendant embezzles \$10, adds \$10 of his own, and then withdraws \$15, the victim may claim the \$5 remaining in the fund. What may the victim claim if after the wrongdoer withdraws and dissipates some of the victim's items, the wrongdoer adds new, legitimately acquired items to the pool? For example, suppose the defendant above, after withdrawing \$15, adds \$5 to the fund. Can the plaintiff now claim specifically the entire \$10 fund? Most courts hold that, absent an actual intent on the part of the wrongdoer to restore the victim's money, the victim cannot claim any ownership of the newly deposited \$5. As a consequence, the plaintiff necessarily is limited to the lowest intermediate balance in the pool between the time that his money was added and the time of judgment. *See Republic Supply Co. v. Richfield Oil Co.*,

offers a mechanical solution to the withdrawal problem, a solution that avoids any inquiry into the actual gain made by Wrongdoer as a result of his conversion of Owner-One's dollar bill. The doctrine makes no serious effort to link the formulas with calculations of Wrongdoer's gain in "average" cases so as to justify them as legitimate approximations.⁶⁷ Furthermore, the rules cannot be justified as resolving all doubts in favor of the victim, for they often create presumptions that favor the wrongdoer: for example, in applying the lowest intermediate balance limitation, later deposits are not regarded as a restitution of the victim's fund.⁶⁸

V

THE EFFECT OF TRACING ON CREDITOR'S RIGHTS

When dissimilar claimants seek satisfaction from an insufficient

79 F.2d 375 (9th Cir. 1935). A few courts disagree, however, and presume an intent on the part of the wrongdoer to restore the victim's funds, thereby allowing the victim to claim specifically the new deposits as well as any items from the original pool. *E.g.*, *Church v. Bailey*, 90 Cal. App. 2d 501, 203 P.2d 547 (1949); *Myers v. Mausek*, 98 Fla. 1126, 125 So. 360 (1929).

Finally, substantial complications arise when the items withdrawn from the mixed fund are exchanged for identifiable property. For example, if the property acquired with the fund appreciates in value, may the victim augment his claim by tracing into the appreciated property? The wrongdoer embezzles \$10, adds \$10 of his own, and withdraws \$10 which he exchanges for \$20 in bearer bonds. Is the victim limited to a claim on the \$10 remaining in the fund, or may he claim the \$20 bearer bonds? American courts are divided and one can find at least three distinct theories in the literature. First, following a 1903 English decision, *In re Oatway*, 2 Ch. 356 (1903), some courts offer the victim the option of tracing the withdrawals into the appreciated property or of treating the remainder of the fund as his own. *See Republic Supply Co. v. Richfield Oil Co.*, 79 F.2d 375 (9th Cir. 1935); *General Ass'n of Davidian Seventh Day Adventists, Inc. v. General Ass'n of Davidian Seventh Day Adventists*, 410 S.W.2d 256 (Tex. Civ. App. 1966). Other courts strictly follow the Rule of Jessel's Bag, presuming all withdrawals to be the wrongdoer's property until the remaining fund is less than the victim's loss. *Covey v. Cannon*, 105 Ark. 550, 159 S.W. 514 (1912). Finally, under the Restatement of Restitution, which courts largely have not accepted, the victim may only claim an equitable lien on both the fund and the product of any withdrawals in the amount of his loss, or a constructive trust for a proportionate share in both the fund and the product of any withdrawals. *RESTATEMENT OF RESTITUTION* §§ 210, 211 (1936). The proportionate share is based on a comparison of victim's involuntary contribution to the whole amount of the fund at the time of the withdrawals.

⁶⁷ By way of comparison, consider the more workable doctrine of "confusion" developed in the at-law courts as a remedy for the commingling of indistinguishable goods that can be reapportioned (grain). Early courts held that in cases of willful confusion, the wrongdoer forfeits the claim to the entire mass. *E.g.*, *Dillingham v. Smith*, 30 Me. 370 (1849); *Ryder v. Hathaway*, 21 Mass. 298 (1883). Most modern courts will apportion the pool of assets, but place the burden on the wrongdoer to prove which portion of the pool is his. *See, e.g.*, *Troop v. St. Louis Union Trust Co.*, 25 Ill. App. 2d 143, 166 N.E.2d 116 (1960); *Sommers v. Kane*, 168 Minn. 420, 210 N.W. 287 (1926). Under the modern view, the doctrine offers the plaintiff an advantage over a simple damages remedy for conversion when the value of the lost goods has appreciated since the time of the commingling (replevin enables the plaintiff to share in the appreciation), and when the wrongdoer is insolvent (replevin enables the plaintiff to take ahead of other creditors).

⁶⁸ *See Republic Supply Co. v. Richfield Oil Co.*, 79 F.2d 375 (9th Cir. 1935).

pool of assets, the law usually allocates the assets by establishing priorities among the claimants. Tracing doctrine alters these priorities to the extent that it grants select claimants ownership interests in traceable assets within the pool. Assume that Wrongdoer steals silver teapots from Owner-One and Owner-Two and exchanges one of them for a guitar, and that furthermore Wrongdoer has two creditors: Creditor-One, with a secured interest in the guitar, and Creditor-Two, a general creditor. Tracing allows Owner-One to claim the guitar free from the claims of either the secured or the general creditor. Owner-Two's claim on the guitar is subordinate to that of Creditor-One and on par with that of Creditor-Two.⁶⁹ In essence, tracing is a crude standard for segregating those victims of misappropriations whose assets have augmented the wrongdoer's wealth to the benefit of the wrongdoer's creditors, from those victims of misappropriations whose assets have not augmented the wrongdoer's wealth to the benefit of the wrongdoer's creditors.⁷⁰ Because of its dependence on select transactional links rather than causal links between the items misappropriated and the items in the wrongdoer's hands a traditional tracing doctrine is simply not an acceptable means of determining whether the wrongdoer's creditors are in fact benefiting from the victim's loss. Perhaps a more sensible solution would be to assume that a wrongdoer's creditors benefit from misappropriations that occur within a set time of the satisfaction (total or partial) of the creditor's claims.

Apart from the frequent inequity of discriminating between Owner-One and Owner-Two in the foregoing type of case, a serious question also arises whether any priority of Owner-One over Creditor-One and Creditor-Two is based on a historical anachronism or on a careful evaluation of the comparative equities of all the claimants. Priority for Owner-One may be justified if one accepts the argument that Owner-One, as an innocent victim, is more equitably entitled to the wrongdoing

⁶⁹ Owner-Two may be slightly better off than Creditor-Two if Wrongdoer is in bankruptcy proceedings, however. Owner-Two may be entitled to a decree of nondischargeability. *See In re Transport Clearings-Midwest, Inc.*, 16 Bankr. 890 (W.D. Mo. 1979) (tracing not a condition of a decree of nondischargeability). *But see In re Whitlock*, 449 F. Supp. 1383 (W.D. Mo. 1978) (tracing required for decree of nondischargeability). If so, the unsatisfied part of Owner-Two's claim will survive the bankruptcy proceeding, but Creditor-Two's claim will not.

⁷⁰ *See, e.g., id.*; *Brennan v. Tillinghast*, 201 F. 609 (6th Cir. 1913); *In re J.M. Acheson Co.*, 170 F. 427 (9th Cir. 1909); *Atlas, Inc. v. United States*, 459 F. Supp. 1000 (D.N.D. 1978); *Lucianna v. Hip Sing Ass'n*, 256 A.2d 898 (D.C. 1969). The debtor's bankruptcy brings the same result. The Bankruptcy Code excludes from the bankrupt's estate property to "the extent of any equitable interest in such property that the debtor does not hold." 11 U.S.C. § 541(d) (Supp. IV 1980). The Senate Report implies that the term "equitable interest" includes claims based on constructive trust. S. REP. NO. 989, 95th Cong., 2d Sess. 82, 82, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5868. For an attack on the use of equitable devices to undermine the policy of bankruptcy legislation, see McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 341, 389-90 (1927).

debtor's remaining assets than are creditors, who intentionally assume the risk of the debtor's insolvency when lending money. Perhaps creditors can better protect their own interests and should not be awarded recovery at the expense of a nonconsensual claimant.⁷¹ Indeed, priority for both Owner-One and Owner-Two may be justified by the foregoing analysis. Moreover, this argument also would hold for all victims of conversion, not just those pressing restitutionary claims. Yet, Owner-Two's status in current law (which, in contrast to Owner-One's status, is decided without reference to tracing) suggests that once tracing is eliminated, neither Owner-One nor Owner-Two should be preferred to secured creditors, and that they should take equally with general creditors. In defense of this view, one could argue that Owner-One and Owner-Two are not without their own means of protection. They can take steps to protect their property (e.g., buy locks) and obtain property insurance against misappropriations.⁷² In any event, whether one accepts or rejects a general priority for involuntary claimants over secured creditors, mere reference to the ancient constructs of equitable ownership should not control the decision.

One can draw the same conclusion for the commingled-fund branch of the tracing doctrine. In the commingling example of the previous section,⁷³ the priority of secured and general creditors depends on whether Owner-One or Owner-Two can trace into the fund of indistinguishable dollar bills. Owner-One can identify a specific fund containing converted money commingled with other funds and is assumed to have benefited the wrongdoer's creditors, while Owner-Two, who can state only that his money was converted by the wrongdoer, is conclusively presumed not to have benefited the wrongdoer's creditors. Those writers arguing for the so-called swollen assets theory in the 1930s rightly contested the fairness of this test.⁷⁴ Decisionmakers only accentuate the folly when, under the pretext of measuring the creditors' unjust benefit at Owner-One's expense, they use the traditional tracing rules for commingled funds to calculate the amount of Owner-One's priority in the event of withdrawals from the fund. The fact that Owner-One or even Owner-Two can trace, however, should carry little weight compared to the arguments noted above for and against recognizing a

⁷¹ See D. DOBBS, *supra* note 1, for a typical illustration of one who argues for a preference for those who can trace and invokes, in essence, an argument for a preference for *all* misappropriation victims whose assets augment the defendant's wealth:

[A] part of the profit made by the defendant from his fraud, would inure to the benefit of the creditors, at the expense of the plaintiff. This would, in a sense, unjustly enrich X's creditors, and thus a constructive trust is here again a proper device to enforce restitution to the plaintiff.

Id. at 244-45.

⁷² See *supra* text accompanying notes 40-41.

⁷³ See *supra* text accompanying note 66.

⁷⁴ See *supra* note 33.

priority for innocent, unintentional claimants over contractual creditors. This controversy should be resolved largely by comparing the equities of involuntary and voluntary claimants, and not resolved through simple constructs of equitable ownership that favor some involuntary claimants but not others.

The arguments against both exchange and commingled-fund branches of tracing apply to section 9-306 of the Uniform Commercial Code.⁷⁵ I will first treat the section's exchange tracing rule and then turn to its rules on commingled proceeds. The section imposes, as a general rule, a security interest in "identifiable" proceeds received by the debtor from the disposition of collateral.⁷⁶ Courts have held, consistent with the drafter's intentions, that the case law on tracing provides the legal principles that define "identifiable" proceeds. Thus, the section generally adopts exchange tracing—hook, line, and sinker. Whether or not the defendant is subject to insolvency proceedings, a secured creditor may trace proceeds of collateral—provided that the proceeds are not commingled in cash funds and are subject to an appropriately perfected security interest—and thereby preserve his secured status over other general creditors. The provision may favor secured creditors via Article Nine remedies, and thus may disadvantage general creditors, based on the fortuity of the debtor's acts in holding or dissipating the proceeds. The provision may also arbitrarily select between secured creditors. For example, suppose Creditor-One has a security interest in Debtor's old silver teapot and Creditor-Two has a security interest in Debtor's new silver teapot. Debtor sells both teapots and uses the proceeds of the teapot subject to Creditor-Two's interest to buy wine, which he consumes. He places the proceeds of the teapot subject to Creditor-One's interest in a drawer. If Debtor has no other assets, Creditor-One receives all of Debtor's drawer-fund and Creditor-Two receives nothing. The result is unaltered even if Creditor-Two can prove that Debtor did not care which teapot supplied the proceeds for the wine, or that if Debtor had not possessed *both* teapots (so that one teapot could provide funds for wine), he would not have stored the proceeds from the sale of Creditor-One's teapot in the drawer.

One might argue for a distinction between tracing into property misappropriated from completely involuntary victims and tracing into the proceeds of items that are sold subject to a security interest. In the latter case, the claimant has chosen to accept the defendant as a debtor; in the former case, the claimant may be the victim of a conversion by a stranger. Perhaps the disadvantage to the secured creditor who cannot

⁷⁵ U.C.C. § 9-306 (1978).

⁷⁶ *Id.* § 9-306(2). This is a codification of pre-Code common law. *See, e.g., In re Gibson Prod.*, 543 F.2d 652, 655 (9th Cir.), *cert. denied*, 430 U.S. 946 (1976); 2 G. GILMORE, *supra* note 28, § 45.9.

trace, Creditor-Two in the above example, is justified because he should have taken more care in choosing to lend or sell to Debtor, or in policing his collateral, or in taking a security interest in both teapots. Of course, the arguments favoring involuntary victims would also favor victims of misappropriation by strangers over victims of misappropriation by trustees and corporate fiduciaries who were chosen to manage the misappropriated property. Denial of a right to trace by such beneficiaries may be justified by their failure to select or police the disobedient fiduciaries with more care. The problem with such a distinction here, however, is that the lack of care (or assumption of risk) argument extends in most cases also to those who can trace, such as Creditor-One, *and those who cannot*, such as Creditor-Two. Only in the unusual case in which Creditor-One detects the misappropriation swiftly, and takes steps to locate traceable property before the trail of exchanges becomes obscured (and which otherwise would have become obscured absent his efforts), should Creditor-One be better off than Creditor-Two, who in fact failed to take similar steps to protect his interest. But the unusual case does not support a conclusive presumption that *all* Creditor-Ones, who can trace, acted with due care while *all* Creditor-Twos, who cannot trace acted irresponsibly.

It may be that exchange tracing in Article Nine survives because, like most applications of tracing, it has deceptive intuitive appeal. At first blush, the exchange rule appears necessary to prevent debtors from frustrating secured creditors by selling the collateral to eliminate the security interest. The rule, however, offers only partial protection. Debtors may still frustrate secured creditors by selling the collateral and dissipating the proceeds to eliminate the security interest. This, of course, reinforces the general argument set forth here that there is no a priori reason for favoring creditors who can trace over those who cannot. It may be that a better rule would create a new class of creditors—secured creditors whose collateral has been wrongfully sold—and would compare their positions with those of other secured and general creditors. Should *all* such once-secured creditors receive some priority in debtor's assets? Should we hold that secured creditors have assumed the risk of all wrongful disposal of collateral, or should we say that they have only assumed the risk of the nontraceability of proceeds from wrongful disposal of the collateral (the current rule)? Here I defer to those with expertise in Article Nine for a solution. Perhaps they should promulgate a modified rule: If the proceeds were received within ten days of insolvency, we assume that unsecured creditors were paid off or otherwise benefited unjustly from the proceeds. This latter approach seems more sensible than the current exchange rule, which favors select secured creditors following proceeds. Indeed, section 9-306(4)(d) now

uses the latter approach in the context of tracing into commingled cash proceeds held by a debtor subject to insolvency proceedings.

For the debtor who commingles cash proceeds, the Code adopts, with a revealing exception for insolvency proceedings, the old equity courts' tracing rules for commingled funds.⁷⁷ The problems noted above on the effect of such rules therefore apply to section 9-306; certain secured creditors are favored somewhat over others similarly situated solely because of the transactional link between the cash proceeds and an identifiable fund.

Secured creditors who can find a fund containing cash proceeds commingled with the debtor's other funds can claim security in some or all of the fund through the use of equitable tracing doctrines. In the event of the debtor's insolvency and if there are no insolvency proceedings (in which case section 9-306(4)(d) applies), a secured creditor who can trace will do better than one who cannot. Again, tracing creates a conclusive presumption that a secured creditor who can trace proceeds into a commingled fund has identified proceeds that have augmented the debtor's assets to the benefit of other creditors and a secured creditor who cannot trace may not argue that the proceeds in which he has an interest have augmented the debtor's assets. Even absent insolvency tracing provides an advantage; the secured creditor who can trace his security interest into a commingled fund thereby retains Article Nine rights and remedies whereas a secured creditor who cannot trace is left with a simple money claim. Of particular interest, however, is the exception contained in section 9-306(4)(d)(ii) that reflects, in part, an acceptance in the context of insolvency proceedings of the arguments *against* commingled-fund tracing outlined above.⁷⁸ The subdivision applies in insolvency proceedings and permits a secured party with a perfected security interest in proceeds to claim cash and deposit accounts containing commingled cash proceeds, but limits this interest to an amount not greater than the amount of any cash proceeds received by the debtor within ten days of the proceedings (less certain deductions).⁷⁹

⁷⁷ Section 9-306(2) of the Uniform Commercial Code incorporates the commingling branch of tracing. If a debtor sells collateral and commingles the proceeds with other funds or property, the creditor can trace into the fund to assert a security interest on the proceeds. *See* Michigan Nat'l Bank v. Flowers Mobile Homes Sales, 26 N.C. App. 690, 217 S.E.2d 108 (1975); Girard Trust Corn Exch. Bank v. Warren Lепley Ford, Inc., 25 Pa. D & C.2d 395, 1 U.C.C. REP. SERV. 531 (Callaghan) (1958); U.C.C. § 9-306 comment 2 (1978); 2 G. GILMORE, *supra* note 28, § 45.9. Courts also hold that if the debtor makes withdrawals from the commingled fund, the Rule of Jessel's Bag applies in a calculation of the amount of the security interest that attaches to the fund. *See* Brown & Williamson Tobacco Corp. v. First Nat'l Bank, 504 F.2d 998 (7th Cir. 1974); *supra* note 66. The Uniform Commercial Code, in § 9-306(4)(d), however, fashions an important exception to traditional commingling fictions. *See infra* text accompanying notes 79-84.

⁷⁸ *See supra* notes 66-67 and accompanying text.

⁷⁹ *See supra* text accompanying notes 66-67. The language in U.C.C. § 9-306(4)(d)(ii) (1978) referring to "the amount of any cash proceeds received by the debtor" has led to some

The drafters apparently decided that as a general matter secured creditors who can trace proceeds into a specific fund subject to insolvency proceedings do not deserve priority over general creditors and secured creditors who cannot trace. One could argue that the rejection of tracing here reflects my position that tracing inaccurately distinguishes between creditors following proceeds that have augmented the debtors' estate and proceeds that have not augmented the estate. The evidence, however, is to the contrary. Apparently, the rule was designed to penalize creditors who could otherwise trace the proceeds in the hope that creditors would better police their interests and prevent commingling.⁸⁰ Thus interpreted, the section's use of commingled-fund tracing to aid select creditors outside of insolvency proceedings (even though there is insolvency in fact) is surprising.

The ten-day rule, however, which grants a limited priority to creditors following cash proceeds into commingled funds, does seem to be premised on a rejection of the core reasons behind tracing. The priority does not depend on identifying a specific fund containing proceeds in which the secured party had an interest.⁸¹ It is defended with a version of the "swollen assets" theory that commentators otherwise reject.⁸² The bank accounts of a typical debtor who is subject to insolvency proceedings, the argument goes, contain mostly, if not exclusively, proceeds. Even if a creditor's proceeds that the debtor receives within the ten-day period are not in fact in the account, the other creditors cannot complain; the proceeds most likely went to other creditors, diminishing their claims on the debtor's assets.⁸³ One may ask, however, why this ration-

confusion. Compare *Fitzpatrick v. Philco Fin. Corp.*, 491 F.2d 1288 (7th Cir. 1974) (statute refers to proceeds from the collateral held for plaintiff) with *In re Gibson Prods.*, 543 F.2d 652 (9th Cir.), cert. denied, 430 U.S. 946 (1976) (statute refers to all receipts from any source). See generally *In re Guaranted Muffler Supply Co.*, 5 Bankr. 236, 238 (N.D. Ga. 1980) (criticizing *Gibson* and following *Fitzpatrick*). A second textual difficulty with the section concerns the requirement that other "proceeds have been commingled with other funds." What if cash proceeds that are received by the debtor within 10 days of the commencement of insolvency proceedings, are dissipated before the date of filing but are not in fact commingled with other funds while in the debtor's hands? Is the creditor with an interest in the proceeds excluded from the benefit of § 9-306(4)(d)(ii)? Moreover, the language of § 547(b), (e) of the Bankruptcy Act of 1978 may affect the operation of § 9-306(4) in bankruptcy proceedings. See 11 U.S.C. § 547(b), (e) (Supp. IV 1980). The Act may render voidable the creditor's claim in the proceeds as a preference. See Eisenberg, *Bankruptcy Law In Perspective*, 28 U.C.L.A. L. REV. 953, 962 n.27 (1981).

⁸⁰ 2 G. GILMORE, *supra* note 28, § 45.9, at 1338-39.

⁸¹ 2 G. GILMORE, *supra* note 28, § 45.9, at 1340, 1344.

⁸² See *supra* note 33.

⁸³ J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 1014 (2d ed. 1980). ("[Other creditors] have no complaints, for they have been made fat off the secured creditor's proceeds and are in the same position as they would have been had the money in the account been paid to them and the proceeds been put into the account."). Professor Gilmore may favor a different rationale. In his treatise he seems to justify the lack of any identification requirement on the ground that, given the limited nature of a § 9-306(4)(d) claim, the account will probably in fact contain more of the secured credi-

ale does not apply to aid creditors other than those following cash proceeds. If a debtor receives non-cash proceeds (or cash proceeds that have not been commingled) within ten days of an insolvency proceeding, and the proceeds cannot be identified in the debtor's estate at the time insolvency proceedings are instituted, should we assume that the proceeds have gone to other creditors?

VII

TRACING AND THIRD-PARTY TRANSFEREES

The problems that tracing causes when creditors are involved are mirrored in the cases involving innocent donees.⁸⁴ Recall the original

tor's proceeds than the 10-day rule will allow him to claim. See 2 G. GILMORE, *supra* note 28, § 45.9, at 1339 ("[W]hat will be in the debtor's account on the date of insolvency . . . will have come from deposits of proceeds [owing to his inventory finances] to a much greater extent than the carefully limited amount of the claim."). Apparently, the rationale for penalizing secured creditors who do not police their rights, see *supra* note 80, does not apply in this case. Even so, the 10-day rule should be recognized as providing the reverse of the presumption behind tracing doctrine. According to Gilmore, all creditors following cash proceeds received by the debtor within ten days of insolvency are presumed deserving of preference regardless of their ability to identify a specific fund containing those proceeds.

⁸⁴ A necessary incident of *Newton v. Porter*, 69 N.Y. 133 (1877), see *supra* note 51, is the creation of a special set of rules for innocent converters who became, after the case, subject to tracing. These rules most commonly apply to innocent transferees of the wrongdoer who receive traceable property. Of interest is why *Newton* stimulated the development of these special rules.

When tracing applied only to trustee or fiduciary misappropriations the courts did not distinguish between innocent and knowledgeable conversions. The treatment of innocent misappropriations by trustees has long been settled; equity courts order tracing relief against a trustee whether or not his breach of trust is innocent or conscious. See, e.g., *Loring v. Baker*, 329 Mass. 63, 106 N.E.2d 434 (1952); see 1 G. PALMER, *supra* note 1, § 2.14(b); 3 A. SCOTT, *supra* note 1, at § 201. For example, if a trustee, erroneously believing that he has a right to a salary from the trust res, invests a portion of the res in stock for his own account, and through extensive stock trading thereafter augments this account, the beneficiary receives an equitable interest in all of the newly acquired stock in the account at the time of judgment. *Thompson v. Nesheim*, 280 Minn. 407, 159 N.W.2d 910 (1968); see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Clayton*, 488 F.2d 974 (5th Cir. 1974); see also *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 891 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976). This remedy seems appropriate because the trust res, if properly invested by the trustee, would have (or could have) produced the same stock. In this sense, the trustee not only deprived the beneficiary of the misappropriated property, but also of the trustee's skills in managing or investing the misappropriated property. The actual product of his efforts, therefore, is a good measure of the loss. See *supra* text accompanying note 53. A similar argument applies to innocent conversions by fiduciaries. Most such conversions, even if innocent, involve the diversion of property from the plaintiff's account that the fiduciary should have invested for the plaintiff's benefit. The *Restatement*, therefore, favors full tracing relief against all fiduciaries. See *RESTATEMENT OF RESTITUTION* § 198 (1936). Scattered cases agree. See, e.g., *Production Mach. Co. v. Howe*, 327 Mass. 372, 99 N.E.2d 32 (1951).

Innocent nonfiduciary conversions, supporting tracing relief only after *Newton*, are significantly dissimilar; an innocent converter does not typically withhold management or investment services from the plaintiff. Consider the following example. Donee innocently buys stolen goods for \$100 and exchanges the goods for stock, which he parlays through a series of exchanges into stock worth \$200. Should the owner of the goods be given an equitable interest in the stock and be allowed to claim the stock *in specie* at a personal profit of \$100? Most

example in Section IV (Wrongdoer steals teapots from Owner-One and Owner-Two, and exchanges one of the teapots for a guitar). If Wrongdoer transfers the guitar to a gratuitous, innocent Donee, courts allow Owner-One to charge Donee as a constructive trustee of the guitar. Owner-One's equitable ownership interest attaches to the guitar, and he can reclaim it even if Wrongdoer is solvent and available to be sued. Owner-Two, on the other hand, has no claim against Donee unless Owner-Two can prove that Wrongdoer's transfer defrauded creditors or is voidable by a trustee in bankruptcy.⁸⁵ Even if Owner-Two proves a

commentators favor limiting Owner to an equitable lien on the stock equal to the amount of the misappropriation. See, e.g., D. DOBBS, *supra* note 1, at 243; 1 G. PALMER, *supra* note 1, § 2.14(9b); 5 A. SCOTT, *supra* note 1, § 509. The words of Professor Dobbs are typical: "Where there is no intentional misdealing, the constructive trustee probably should not be held liable for gains made in dealing with the property, except those that the plaintiff would clearly have had for himself if he had retained the property all along." D. DOBBS, *supra* note 1, at 243; accord RESTATEMENT OF RESTITUTION § 203 (1936). In addition, if the stock depreciates in value below the value of the stolen goods (here \$100), commentators favor granting Donee the option of returning to Owner the stock *in specie* in full satisfaction of Owner's claim. See RESTATEMENT OF RESTITUTION § 203 (1936). This theory of differentiating recovery on the basis of mental state may be explained by either of two rationales. First, a removal of the profit motive adds a measure of deterrence against willful misconduct that is unnecessary in cases of innocent misconduct. Second, a gain that is acquired through willful misconduct is morally illegitimate, but a profit made through innocent misconduct is morally legitimate.

The distinction between *bona fide* and *mala fide* misappropriations appears to have originated in 1906 with Ames. See Ames, *supra* note 1, at 515-16. But see Dawson, *supra* note 8, at 614 (distinction first "appeared in 1937 when the *Restatement* was published"). No case law on the subject, however, exists. The reporter's notes to the *Restatement* refer to Dixon v. Caldwell, 15 Ohio St. 412 (1864) as supporting authority. The court in *Dixon*, however, effectively denied *any* tracing relief to the victim of an innocent converter, and commentators who argue that the case governs the type of tracing relief available against such converters stretch the decision.

Those who support special tracing rules for innocent converters do not deny the victim all constructive-trust relief, however. Rather, they would preserve for the victim constructive-trust relief against any "direct product" of the misappropriated property. The *Restatement* defines "direct product" as "that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor." RESTATEMENT OF RESTITUTION § 157 comment b (1936). The concept thus distinguishes types of income received by an innocent converter or gratuitous transferee from misappropriated property and protects some income from full-blown tracing claims. For example, Owner, induced by Wrongdoer's fraud, transfers Blackacre to Third Party, who is innocent and without knowledge of the fraud. Owner reclaims the property and seeks to trace into the income that Third Party acquired as a result of his use of the land. Third Party must account to Owner for any rent that Third Party received from a lease existing *before* the transfer. Moreover, if the rent proceeds can be identified, Owner can trace into and impose a constructive trust on the fund. On the other hand, if Third Party receives rent on a lease that he negotiates *after* he acquires title, he must account to Owner for the actual rents paid, up to the market rental value of the land. Owner bears the loss, if any, of Third Party's failure to use the property profitably, and Third Party retains any premium rental that he obtains over market rates. Thus, if the rental payment can be identified, Owner can trace into the rent proceeds and, if the fund exceeds the market rental value, impose only an equitable lien equal to the market rental value on the fund.

⁸⁵ The Bankruptcy Reform Act of 1978 empowers the bankruptcy trustee to invalidate certain pre-bankruptcy transfers. The property then becomes property of the estate and sub-

voidable transfer in bankruptcy, however, he receives scant benefit, because he must divide the value of Donee's guitar with other creditors.

Although situations in which Wrongdoer is solvent will rarely arise, Owner-One's ability to sue either Wrongdoer or Donee demonstrates the current strength of the old equitable-ownership notions. Indeed, if the guitar has appreciated in Donee's hands, Owner-One is encouraged to sue Donee rather than Wrongdoer in order to obtain the gain from that appreciation.⁸⁶ If Owner-One does elect to sue only the innocent third party, the solvent wrongdoer escapes liability and is subject only to the frustration of having his gift to Donee voided.

If Wrongdoer is insolvent or cannot be found, the merits of a claim by Owner-One or Owner-Two against Donee are more weighty. Donee holds a gift from Wrongdoer and, unless he has changed his position in reliance on his continuing ownership of the gift,⁸⁷ Donee gains at no cost, while Owner-One and Owner-Two suffer injury. If Donee can restore Owner-One's and Owner-Two's losses, all three parties are restored to their position before Wrongdoer's acts. Identifying the class of third parties susceptible to suit, unfortunately, is a difficult task. Should all individuals receiving gifts from Wrongdoer after the time of his thefts be liable to the victims? The tracing rules provide a certain, but arbitrary method of selection: If Owner-One can trace property into the hands of a donee, he may sue that donee.

Thus, the rule favors both select claimants who can trace and select third parties who hold untraceable gifts from Wrongdoer. For example, assume that Wrongdoer, when he stole the silver teapots from Owner-One and Owner-Two, had \$100 in his pocket. Thereafter, Wrongdoer exchanges Owner-One's teapot for a pink guitar, which he gives to Donee-One, and exchanges the \$100 in his pocket for a green guitar, which he gives to Donee-Two. Owner-Two's teapot is exchanged for wine, which Wrongdoer consumes. Owner-One may claim the pink guitar from Donee-One. Yet Owner-Two cannot sue Donee-Two unless the transfer of the green guitar was a fraud on Wrongdoer's creditors. The result is unaltered if Donee-One, attempting to convince the court that Donee-Two should share equally liability for Wrongdoer's act, proves that Wrongdoer distributed the guitars to Donee-One and Donee-Two

ject to the creditors' claims. Voidable transfers include fraudulent conveyances and preferences. *See* 11 U.S.C. §§ 544(b), 547(b), 548 (Supp. IV 1980). If the wrongdoer is a corporation, state receivership law may also apply. *See, e.g.,* *Gallagher v. Keystone Realty Holding Co.*, 333 Pa. 9, 3 A.2d 426 (1939). *But see In re Wisconsin Builders Supply Co.*, 239 F.2d 649 (7th Cir. 1956) (federal bankruptcy law suspends sections of Wisconsin insolvency statutes providing for commencement of involuntary proceedings against insolvent), *cert. denied*, 353 U.S. 985 (1957).

⁸⁶ Donee, of course, has no claim against Wrongdoer for the loss of the gift.

⁸⁷ *See generally* RESTATEMENT OF RESTITUTION § 142 (1936); Dawson, *supra* note 8, at 567-76.

by lot. Instead, courts assume that Donee-One has benefited unjustly as a result of the first theft but that Donee-Two has not so benefited as a result of the second theft. Moreover, Owner-Two has no claim against either Donee-One or Donee-Two.

A better rule would equalize the positions of Owner-One and Owner-Two as well as those of Donee-One and Donee-Two. The following is an example: All gratuitous donees of Wrongdoer that receive their gifts ninety days before or anytime after Wrongdoer's insolvency are jointly and severally liable (with a right of contribution from each other) for the amount of Wrongdoer's wrongful appropriations to the extent of the gift to each.⁸⁸ A second, and perhaps more sensible, alternative would totally eliminate the effect of the tracing fictions and defer to fraudulent-conveyance doctrine or bankruptcy law wherever claims against bona fide donees of the wrongdoer are in issue; neither Owner-One nor Owner-Two could prevail in his claim against either Donee-One or Donee-Two, unless Wrongdoer's gift was a fraudulent conveyance or a transfer voidable by a trustee in bankruptcy.⁸⁹

CONCLUSION

Tracing is not an accurate measure of the defendant's actual benefit from a misappropriation unless he is unable to purchase the traced property with his own funds or is an errant fiduciary who misappropriates assets over which he has management responsibility. Even in cases in which tracing can be justified as a measure of unjustly held benefit, however, the doctrine discriminates arbitrarily between claimants. Moreover, tracing often does not yield sensible results if the outcome affects other creditors of the defendant, the defendant's right to keep exempt property, or third-party donees. In sum, tracing doctrine can serve only as a rough rule of thumb for divesting a defendant of an unjustly acquired gain in a very narrow range of cases—so narrow that

⁸⁸ Cf. 11 U.S.C. § 547(b)(4) (Supp. IV 1980) (trustee may avoid certain transfer of debtor's property made within 90 days before filing of bankruptcy petition). The rule would require Owner-One and Owner-Two to sue Wrongdoer for their loss unless insolvency exists or is imminent. Once insolvency becomes an issue, all gratuitous donees who received gifts 90 days before wrongdoer's insolvency would be presumed to have profited from Wrongdoer's thefts.

⁸⁹ A similar argument applies to question tracing's effect on the exempt property statutes. Under current tracing doctrine if, for example, Wrongdoer, after stealing Owner-One's and Owner-Two's teapots, had exchanged Owner-One's teapot for an automobile that homestead exemption law protects, Owner-One could claim the automobile. *See supra* note 44. Owner-One is construed to have equitable title to the automobile, and Wrongdoer cannot claim an exemption for items to which he does not have full title. Owner-Two obtains, on the other hand, an unsatisfiable personal judgment against Wrongdoer (assuming he has no assets other than the automobile), because the statute restricts the execution of simple judgment debts. Courts assume, therefore, that the Wrongdoer's exempt assets are the product of Owner-One's misappropriation and not the product of Owner-Two's misappropriation.

one wonders whether the doctrine is worth the effort to apply it correctly.

Despite the infrequency of tracing problems in the case law, the doctrine deserves continued and critical attention. The suggestion that courts and lawyers will let tracing fade through disuse, either because they are sensitive to the existing criticisms of tracing or are ignorant of the power of this classic remedy, underestimates the resiliency of the doctrine; tracing has found its way, for example, into Article Nine of the Uniform Commercial Code. In addition, a critical examination of tracing reveals problems with the concept of unjust enrichment generally, and thus questions indirectly the validity of other restitutionary doctrines.

Quasi-contract,⁹⁰ for example, has problems analogous to those of tracing. Quasi-contract, like tracing, often miscalculates the defendant's benefit. Consider Wrongdoer, who using unique personal skills and much personal time, discovers an attractive opportunity: in a nearby state he can sell a type of silver teapot for \$200 that is marketed locally for \$100. Wrongdoer has well over \$100 in the bank in an interest-bearing account, but he instead chooses to steal Owner's teapot to make the sale. The proceeds of the profit on the sale are dissipated; no tracing is possible. Owner secures a money judgment for \$200 through quasi-contract, even though Wrongdoer's real gain from the conversion is more likely the amount of the interest that he was able to collect by not having to use his own money to acquire a suitable teapot for the sale. Moreover, quasi-contract shares with tracing the problems of credit and apportionment. Owner's recovery of the \$200 is automatic. The gain embodied in the sale proceeds is conclusively presumed to be attributable to the property itself and not to the skill and efforts of Wrongdoer; Wrongdoer may not receive a credit for expenses incurred in obtaining the sale proceeds. Thus, if Wrongdoer has personally contributed to the profitability of a successful sale—for example, incurring advertising expenses—he obtains no credit for those contributions. As in tracing, this rule cannot be justified solely on the ground of disgorging a gain, for it penalizes Wrongdoer to the extent of his personal contribution, as well as taking his profit. Is the penalty necessary because the courts cannot administratively investigate the facts of each case, or is the penalty inherently justifiable? As with tracing, a simple reference to the principle

⁹⁰ As far back as 1705, courts have held that the victim of conversion could recover the proceeds from the sale of the converted property by the wrongdoer. The early cases justified the result through a fiction that the plaintiff could "suppose the sale made by his consent, and bring an action for the money [so obtained], as money received to his use." *Lamine v. Dorell*, 2 *Ld. Raym.* 1216, 1216, 92 *Eng. Rep.* 303, 303 (1705). Modern cases base recovery of the sale proceeds on the principle of unjust enrichment: Sale proceeds exceeding the value of the converted property at the time of the conversion represent a gain to the defendant and should be disgorged. *See* RESTATEMENT OF RESTITUTION § 151 comment f (1936).

of unjust enrichment provides no answers.⁹¹

I have in this article challenged the premises of centuries of legal thought on restitutionary remedies. Others may not agree with my conclusions. Even so, if I have led them to rethink these premises, I will have in significant measure accomplished my objectives.

⁹¹ See RESTATEMENT OF RESTITUTION §§ 151, 154 (1936).