

Title

Tracing and recovering real estate wrongfully removed from trusts: End-running the full-faith-and-credit obstacle

Text

Judgments of the courts of the state where entrusted land is sited are binding on the courts of the other states with respect to the land. See 7 Scott & Ascher §46.2.3.1. A judgment of a court of a state other than the state where a parcel of real estate is located cannot “directly” affect interests in the land, although it may indirectly do so if it has personal jurisdiction over the claimants, such as by “imposing personal obligations on the parties over whom it has jurisdiction, enforceable by suit in the state of the situs...[of the land]..., or by application at the situs of the doctrine of *res judicata* or the doctrine of collateral estoppel.” 7 Scott & Ascher §46.2.3.2.

For an example of what “imposing personal obligations” in a multijurisdictional setting looks like in practice in the trust context, see *Hirchert Family Trust v. Hirchert*, 65 So.3d 548 (Fla. 2011). A parcel of California real estate is the subject of an inter vivos trust administered in California. In violation of the terms of the trust the trustee conveys the real estate to himself in his individual capacity. He then sells the parcel and purchases with the proceeds another California parcel, legal title to which he takes free of trust jointly with his wife. He dies. She then sells that parcel and with the proceeds purchases a parcel of real estate in Florida. Having traced the proceeds from the sale of the California real estate (that has been wrongfully taken out of the California trust) ultimately into the Florida real estate, a California court declares the wife to be a constructive trustee of the Florida real estate and issues an equitable specific-performance order *against her personally* to deed legal title to the Florida real estate to a receiver charged with selling the Florida real estate and remitting the proceeds to the successor trustee of the California trust. The California court has personal jurisdiction over the wife, who is not, with respect to the properties at issue, a BFP. A Florida court enforces the equitable specific-performance order of the California court. The California court’s efforts to take matters into its own hands and itself execute the deed, however, are to no avail, the California court lacking *in rem* jurisdiction over the Florida real estate. In other words, the Florida court declines to give full faith and credit to the California court’s efforts to convey legal title to the Florida real estate via a deed of its own making. Thanks to equity, however, there is more than one way to skin the full-faith-and-credit cat.

The procedural equitable remedy of tracing or following property into its product, is taken up generally in §7.2.3.1.3 of *Loring and Rounds: A Trustee’s Handbook* (2022), which section is reproduced in the appendix immediately below. The Handbook’s 2022 Edition is available at <https://law-store.wolterskluwer.com/s/product/loring-rounds-a-trustees-handbook-2022e-misb/01t4R00000OVWE4QAP>.

Appendix

§7.2.3.1.3 Tracing (Following Property into Its Product) [from *Loring and Rounds: A Trustee's Handbook* (2022), available at <https://law-store.wolterskluwer.com/s/product/loring-rounds-a-trustees-handbook-2022e-misb/01t4R00000OVWE4QAP>.]

*Where a person wrongfully disposes of property of another knowing that the disposition is wrongful and acquires in exchange other property, the other is entitled at his option to enforce either (a) a constructive trust of the property so acquired, or (2) an equitable lien upon it to secure his claim for reimbursement from the wrongdoer.*⁷⁰

Tracing (following property into its product) in the trust context is about going after any *proceeds* from the wrongful disposition of entrusted property.⁷¹ Following *in specie* is about going after the entrusted property itself. Though tracing was thought at one time to be a substantive equitable remedy, the better and current view is that it is a procedure for establishing the chain of evidence from res to res.⁷² Thus, for purposes of this handbook, we are referring to tracing (following property into its product) as a procedural equitable remedy, as opposed to a substantive equitable remedy. An example of a substantive equitable remedy would be the assessment of damages or a specific reparation order.⁷³

The procedural equitable remedy of tracing (following property into its product) is not available to the beneficiary unless the economic value is physically traceable into the hands of the trustee and extant.⁷⁴ “Thus, if a trustee sells trust property and dissipates the proceeds, the beneficiary of the trust is not entitled to priority over other claimants of the trustee. The claimant must prove not only that the wrongdoer once had property legally or equitably belonging to him, but that he still holds the property or property which is in whole or in part its product.”⁷⁵ Commingling the property “in one indistinguishable mass” does not necessarily preclude tracing; a total dissipation of the product, however, would.⁷⁶ A total dissipation would

⁷⁰Restatement of Restitution §202.

⁷¹*See, e.g.,* Lackey v. Lackey, 691 So. 2d 990 (Miss. 1997) (a constructive trust for the benefit of the beneficiary of a certain express trust may be imposed on the proceeds of a certain life insurance policy that are attributable to policy premiums that had been paid from funds embezzled from the express trust, the policy proceeds now being in the hands of presumably innocent third parties).

⁷²W. A. Lee, *Purifying the dialect of equity*, 7(2) Tr. Q. Rev. 20–21 (May 2009) [a STEP publication].

⁷³*See generally* §7.2.3.2 of this handbook (equitable damages); §7.2.3.3 of this handbook (specific reparation).

⁷⁴*See, e.g.,* Jimenez v. Lee, 547 P.2d 126 (Or. 1976) (“The money from the savings bond and savings account are clearly traceable into the bank stock.”).

⁷⁵Restatement of Restitution §215, cmt. a.

⁷⁶Restatement of Restitution §215, cmt. a.

render the beneficiary a mere general creditor of the trustee personally.⁷⁷

Thus, one of the possible advantages of being able to trace (follow into the product) is that “the equitable owner (the restitution claimant) recovers in priority to general creditors, ... [though] ... only to the extent that the creditors would otherwise be unjustly enriched at the owner’s expense.”⁷⁸ But what’s sauce for the goose is sauce for the gander. The beneficiary (the trust) also may not be unjustly enriched.⁷⁹ Thus, when traced property has been put to profitable use, the Restatement (Third) of Restitution and Unjust Enrichment would not allow the beneficiary (the trust) to obtain a recovery in excess of what had been lost if to do so would be at the expense of the trustee’s personal creditors, or at the expense of his innocent surviving dependents.⁸⁰

It is fundamental that the trust property and any income earned on it be kept within the trustee’s control.⁸¹ This obligation extends not only to the property in its original form but to any new form into which it has been changed or converted.⁸² This is what tracing (following property into its product) is about. “What is traced is not the physical asset itself but the value inherent in it.”⁸³ Again, tracing is not a substantive remedy. Rather, it is a mechanism or “process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can probably be regarded as representing his property.”⁸⁴ If the trustee, in breach of trust, allows specific trust property to pass for full value to a purchaser who is innocently unaware of the beneficiary’s equitable interest in the property, *i.e.*, to a BFP,⁸⁵ then the purchaser is entitled

⁷⁷Restatement of Restitution §215, cmt. a. *See, e.g.*, *Jimenez v. Lee*, 547 P.2d 126 (Or. 1976) (“Whether or not the assets of plaintiff’s trust are traceable into a product, defendant is personally liable for that amount which would have accrued to plaintiff had there been no breach of trust.”).

⁷⁸Restatement (Third) of Restitution and Unjust Enrichment §58, cmt. b.

⁷⁹*See, e.g.*, *Jimenez v. Lee*, 547 P.2d 126 (Or. 1976) (“Defendant [self-dealing trustee] is, of course, entitled to deduct the amount which he expended out of the trust estate for plaintiff’s [beneficiary’s] educational needs.”).

⁸⁰Restatement (Third) of Restitution and Unjust Enrichment §61.

⁸¹*See generally* 2A Scott on Trusts §175. *See also* §6.2.1.2 of this handbook (trustee’s duty to segregate and earmark trust property).

⁸²4 Scott & Ascher §24.6 (Following Trust Property into Its Product).

⁸³Lewin ¶41-05 (England). *See also* 4 Scott & Ascher §24.11.2 (Accountability for Proceeds).

⁸⁴*Foskett v. McKeown* [2001] 1 AC 102, 128D; [2002] 2 WLR 1299 (Eng.).

⁸⁵*See* Lewin ¶41-102 through ¶41-127 (England) (discussing the good-faith purchaser for value, *i.e.*, the BFP). As to the United States, *see* §5.4.2 of this handbook (rights of the beneficiary as against BFPs and other transferees of the underlying trust property), §8.3.2 of this handbook (the doctrine of bona fide purchase and its breach of trust notice requirement), and §8.15.63 of this handbook (doctrine of bona fide purchase in the trust context). *See also* §8.3.6 of this handbook (negotiable instruments and the duty of third parties to inquire into the trustee’s authority). For a comparison of the BFP, a creature of equity, with the holder in due course, a creature of law, *see* §8.15.68 of this handbook (holders in due course in the trust context).

to keep the specific property.⁸⁶ The trustee, however, would be accountable to the beneficiary for the proceeds.⁸⁷ For more on the concept of the good faith purchaser for value (BFP), the reader is referred to §8.15.63 of this handbook. If the transferee is not a BFP, then the beneficiary is entitled to follow the asset *in specie* and have the asset itself brought back into the trust, assuming that that is physically possible,⁸⁸ or to trace and recoup its economic value if not, *i.e.*, to follow the property into its product.

It is said that tracing (following property into its product) is concerned with the same person but different assets, while following *in specie* is concerned with the same asset but different persons.⁸⁹ Recovery through following or tracing (following property into its product) is usually effected judicially by the imposition of a constructive trust upon the asset or the proceeds as the case may be,⁹⁰ a topic we take up in §3.3 of this handbook. Again, the constructive trust also is not a substantive equitable remedy. Rather it is a procedural equitable remedy, that is to say an equitable device or mechanism for freezing and securing the followed or traced property so that the court may issue equitable specific performance/enforcement orders with respect to it.⁹¹ It is the specific performance/enforcement order that is the substantive equitable remedy.⁹²

The value to the beneficiary of being able to trace (follow the trust property into its product) is twofold: Any increase in its value since the wrongful disposition accrues to the beneficiary, and the beneficiary with respect to the property obtains priority over the trustee's general creditors.⁹³ Otherwise, the claim against the trustee for breach of trust could well be that of a general creditor.⁹⁴ Again, even if the plaintiff is successful in asserting a trust relationship, the property must still be identified with reasonable precision

⁸⁶*See, e.g.,* Stegemeier v. Magness, 728 A.2d 557 (Del. 1999). *See generally* Restatement (Second) of Trusts §284 §8.3.2 of this handbook (purchasers for value of trust property); Restatement of Restitution, Chap. 13, Introductory Note (1937) (the BFP).

⁸⁷Lewin ¶41-05 (England); 4 Scott & Ascher §24.11.2 (Accountability for Proceeds) (U.S.); Restatement of Restitution §198 ("Where a fiduciary in violation of his duty to the beneficiary disposes of property entrusted to him as fiduciary, he holds any property received in exchange upon a constructive trust for the beneficiary") (U.S.).

⁸⁸*See generally* Bogert §§866, 921, 922; 4 Scott & Ascher §24.11.2 (Accountability for Proceeds). *See also* §7.2.3.9 of this handbook (the equitable relief of specific reparation) and §8.3.2 of this handbook (purchasers for value of trust property).

⁸⁹Lewin ¶41-05.

⁹⁰4 Scott & Ascher §24.6.

⁹¹*See generally* §7.2.3.1.6 (the constructive trust).

⁹²*See generally* §7.2.3.4 of this handbook (specific performance).

⁹³4 Scott & Ascher §§24.11.2 (Accountability for Proceeds), 24.6 (Following Trust Property into Its Product); Restatement (Second) of Trusts §202.

⁹⁴4 Scott & Ascher §§24.11.2 (Accountability for Proceeds), 24.6 (Following Trust Property into Its Product); Restatement (Second) of Trusts §202; Restatement of Restitution §215, cmt. a. *But see* §7.4 of this handbook (noting that claims for money damages against a trustee for fraud, embezzlement, defalcation, or other such acts of willful and malicious injury to a trust are not dischargeable in bankruptcy).

for a tracing order to issue.⁹⁵

The self-dealing factor. Assume *B* is trustee of \$5000 for the benefit of *C*. In breach of trust *B* purchases for himself Blackacre with the money. Immediately thereafter the market value of Blackacre doubles. *C* can charge *B* as constructive trustee of Blackacre for the benefit of *C*, or can hold *B* personally liable for \$5000 and enforce an equitable lien upon Blackacre.⁹⁶ On the other hand, if *B* in good faith misdelivers \$5000 to *X* who then purchases with the funds Blackacre for himself, *X* is unjustly enriched, but only to the tune of \$5000 plus interest. In other words, there is no tracing. The critical difference between the two fact patterns is that in the first the trustee was engaged in fiduciary self-dealing, whereas in the second he had not been personally aggrandized by his breach of trust.⁹⁷ Had *X* received the \$5000 as trustee of another trust, the result would have been the same.⁹⁸ No tracing, no restitution of consequential gains, only the restitution of \$5000 plus interest. "...[R]estitution for an inadvertent breach of trust will not impose a liability for consequential gains if the result would be to strip one innocent beneficiary of a gain and confer it as a windfall on another."⁹⁹ Where there is equal equity, the law shall prevail.¹⁰⁰

Third party's knowing participation in a breach of trust. A third party to a trust relationship who knowingly participates in a breach of trust incurs fiduciary-like liabilities. This is a topic we take up in §7.2.9 of this handbook. Thus, to the extent trust property is wrongfully separated from the trust estate and traceable to the noninnocent third party, the BFP defense is unavailable to the third party. Here is an illustration taken verbatim from the Restatement (Third) of Restitution and Unjust Enrichment:

Title to Owner's restaurant is held by Trustee for owner. Acting without authority, Trustee sells the restaurant to Purchaser, who acquires the property with notice of the breach of trust. The restaurant, now insured for the benefit of the Purchaser, is destroyed by fire. Purchaser's rights under the policy, and any insurance proceeds that may eventually be payable, are the traceable product of Owner's interest in the property. They are held by Purchaser in constructive trust for Owner.¹⁰¹

Tracing funds into a common account or commingled fund. If by ordinary accounting methods the beneficiary can show that trust cash has been deposited to the personal account of the trustee, a lien may be placed upon all the funds in the account.¹⁰² If the trustee is insolvent, the "trust" is entitled to priority over the trustee's general creditors when it comes to satisfying its claim from funds in the account.¹⁰³ To the extent that assets in the account and traceable property that has left the account are insufficient to satisfy

⁹⁵See Bogert §921; Restatement of Restitution §215, cmt. a.

⁹⁶Restatement of Restitution §202, illus. 1.

⁹⁷See generally Restatement (Third) of Restitution and Unjust Enrichment §43.

⁹⁸See generally Restatement (Third) of Restitution and Unjust Enrichment §43, illus. 35.

⁹⁹Restatement (Third) of Restitution and Unjust Enrichment §53, cmt. d.

¹⁰⁰See generally §8.12 of this handbook (equity's maxims).

¹⁰¹Restatement (Third) of Restitution and Unjust Enrichment §58, illus. 13.

¹⁰²See generally Bogert §924; Restatement of Restitution §211, cmt. a.

¹⁰³Restatement of Restitution §209, cmt. a.

the claim, the trust becomes a personal general creditor of the trustee for the balance owed.¹⁰⁴

It should be noted, however, that in the past if there had been incremental withdrawals from an account in which trust funds and the personal funds of the trustee had been commingled, a court might well have felt the need to make a determination as to whose money it was, the trustee's or the trust's. The determination, which was based on certain traditional presumptions and fictions, could well have had varying economic consequences for the parties, *i.e.*, the trust beneficiaries and the trustee's personal creditors, particularly if the balance in the account was less than the claim and the money that had been withdrawn had subsequently been dissipated, or if the money that was withdrawn had been invested in an asset that had appreciated and what remained in the account had been dissipated. Many courts, both here and in England,¹⁰⁵ felt constrained to apply one or more of the following presumptions, a process that Professor Scott felt has unnecessarily muddied the waters:

- The trustee was presumed to have withdrawn his own money first.
- The one, be it the trustee or the “trust,” whose funds had first entered the account was deemed the owner of the funds that had first exited the account.
- The trustee was presumed to have acted honestly, and pursued a withdrawal program that was most advantageous to the trust.

The Restatement of Restitution (1937) would limit tracing in such circumstances to the proportion that the trust's money bore to the total of the commingled fund at the time of the wrongful withdrawal by the trustee.¹⁰⁶ “In part, at least, the impetus of the proportionality rule...was a concern that the claimant might otherwise obtain a fortuitous windfall recovery at the expense of the recipient's general creditors.”¹⁰⁷

The approach of the Restatement (Third) of Restitution and Unjust Enrichment to such withdrawals has more of an equitable flavor to it than either the traditional approach or the approach of the 1937 Restatement. Disadvantageous or untraceable withdrawals are attributed to the wrongdoing trustee's personal funds, to the extent the available balance permits.¹⁰⁸ Conversely, any withdrawal that yields a traceable product may be attributable to the trustee's personal funds to the extent the beneficiaries so elect and the available balance permits.¹⁰⁹ This dual presumption in favor of the trust beneficiaries is “counterbalanced” by an “equally significant” presumption in favor of the trustee (and, by extension, in favor of the trustee's personal creditors). Here it is: A contribution by the trustee to the common fund postwithdrawal is not put toward making the trust estate whole, unless it can be shown that the trustee affirmatively intended otherwise.¹¹⁰

Warning: The much-criticized Rule in Clayton's Case, covered in §8.15.11 of this handbook, is inapplicable to commingling of trust funds with the trustee's personal funds. The Rule in Clayton's Case,

¹⁰⁴Restatement of Restitution §215, cmt. a.

¹⁰⁵For a discussion of the English bank account tracing cases, *see* Mark Pawlowski, *Tracing into Assets*, Tr. & Est. L.J., No. 40 (Oct. 2002), at 4.

¹⁰⁶Restatement of Restitution §§210-211 (1937).

¹⁰⁷Restatement (Third) of Restitution and Unjust Enrichment §59, cmt. d.

¹⁰⁸Restatement (Third) of Restitution and Unjust Enrichment §59, cmt. d.

¹⁰⁹Restatement (Third) of Restitution and Unjust Enrichment §59, cmt. d.

¹¹⁰Restatement (Third) of Restitution and Unjust Enrichment §59, cmt. d.

which takes a “first in, first out” approach, applies when the trustee has commingled the funds of two or more trusts in a single account. In any case, the Restatement of Restitution is not in accord with Clayton: “Where a person wrongfully mingles money of two or more persons and subsequently wrongfully withdraws and dissipates a part of the money, the claimants are entitled to share the balance proportionately....It is immaterial in what order the deposits were made....”¹¹¹ In other words, the equality is equity maxim informs tracing doctrine in cases where the assets of multiple trusts are wrongly commingled in a single fund.¹¹²

All profits gained by verifiable use of the trust fund belong to the trust estate and not to the trustee. This is true whether the profits have been gained rightfully or wrongfully. “The principle is that, in the management of a trust, the trustee may lose but cannot gain.”¹¹³ Otherwise, the trustee would be unjustly enriched. The subject of unjust enrichment is taken up in §8.15.78 of this handbook.

¹¹¹Restatement of Restitution §213, cmt. c.

¹¹²*See, e.g., In re Mich. Boiler & Eng’g Co.*, 171 B.R. 565 (Bankr. E.D. Mich. 1993). The equity maxims are covered generally in §8.12 of this handbook.

¹¹³*Baker v. Disbrow*, 18 Hun 29, 30 (N.Y. Sup. Ct. 1879), *aff’d mem.* 79 N.Y. 631 (1880). *See generally* 4 Scott & Ascher §24.9 (Liability in the Case of a Breach of Trust).