
**SHOULD OWNERS HAVE TO SHARE? AN EXAMINATION
OF FORCED SHARING IN THE NAME OF FAIRNESS IN
RECENT MULTIPLE FRAUD VICTIM CASES**

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* J.D., Boston University School of Law, 2010; B.S. Psychology, Northeastern University, 2006. I would like to thank Professor Andrew Kull for his guidance in choosing and developing this topic. This Note came about as the result of research I did in the summer of 2008 for Professor Kull in his capacity as Official Reporter for the American Law Institute’s Restatement (Third) of Restitution and Unjust Enrichment. The ideas that follow are largely a product of our discussions of that research, and related observations will be made in the Reporter’s Notes of the forthcoming Section 59.

*If the product of the true owner's res is still traceable in the assets of the wrongdoer, in the form of land, chattels, a bank deposit, or the money of a bank, its surrender to the true owner is eminently just.*¹

INTRODUCTION

A modern scholar of restitution notes that “[t]he contemporary treatment of restitution in bankruptcy has become confused and haphazard.”² But restitution principles have become blurred in other areas as well. The “unfamiliar[ity of] most lawyers and judges” with “the common law of restitutionary rights and remedies” has resulted in the application of unusual doctrines and confusing rhetoric with respect to the treatment of multiple fraud claimants.³ In particular, there is confusion with regard to whether tracing should be permitted when there are multiple restitution claims on a single wrongdoer’s assets, and certain claimants can trace into the assets while others cannot.

The Supreme Court, in *Cunningham v. Brown*,⁴ dealt with multiple restitution claimants, victims of the great schemer Charles Ponzi’s fraud, and answered a slightly – but significantly – different question.⁵ Where a number of Ponzi’s more recent victims sought to employ a presumptive tracing rule to gain priority over indistinguishably commingled funds, the Supreme Court denied their claims⁶:

To say that, as between equally innocent victims, the wrongdoer . . . must be *presumed* to have distinguished in advance between the money of those who were about to rescind and those who were not, would be carrying the fiction to a fantastic conclusion.⁷

While denying the application of a presumption with regard to assets that could not be directly traced or separately identified, the Supreme Court underlined that equitable remedies would have been available to the claimants if they had been able to trace, saying:

¹ James Barr Ames, *Following Misappropriated Property into Its Product*, 19 HARV. L. REV. 511, 522 (1906).

² Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265, 265 (1998).

³ *Id.* at 266.

⁴ 265 U.S. 1 (1924).

⁵ *Id.* at 9. The question before the Court was whether Ponzi’s *most recent* victims were entitled to “the presumption . . . that a wrongdoing trustee first withdrew his own money from a fund mingled with that of his *cestui que trustent*, and therefore that the respective deposits of the defendants were still in the bank and available for return to them in rescission” despite their being unable to actually trace into the account or identify their funds. *Id.*

⁶ *See id.* at 13-14.

⁷ *Id.* at 13 (emphasis added).

They had one of two remedies to make them whole. They could have followed the money wherever they could trace it and have asserted possession of it on the ground that there was a resulting trust in their favor, or they could have established a lien for what was due them in any particular fund of which he had made it a part. . . . But to succeed they must trace the money and therein they have failed.⁸

This is orthodox restitution doctrine; these two equitable remedies referred to by the Supreme Court – the constructive trust, and the equitable lien – are available to claimants who, unlike any of Ponzi’s victims, are able to trace or identify assets upon which they have established a proprietary claim.⁹

Despite orthodox restitution doctrine, and despite *Cunningham*, a number of modern cases have denied equitable relief to claimants who actually can trace their assets.¹⁰ The reasoning behind these decisions amounts to the application of an extraordinary new legal phenomenon: a “forced sharing” doctrine requiring claimants with established property-based claims to share pro rata with all other victims. This doctrine denies a specific remedy in restitution to claimants who can identify or directly trace their property in the hands of the wrongdoer simply because there happen to be other victims of the wrongdoer who cannot make such claims. Its justification seems to be nothing more than perceived “unfairness” to claimants who cannot trace.¹¹

⁸ *Id.* at 11.

⁹ See RESTATEMENT OF RESTITUTION, QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS §§ 160-161 (1937); see also RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT §§ 55-56, 58-59 (Tentative Draft No. 6, 2008); GEORGE E. PALMER, THE LAW OF RESTITUTION § 3.4 (1978); LIONEL D. SMITH, THE LAW OF TRACING, 305-10 (1997) (explaining how the common law has chosen tracing as a middle ground between indestructible proprietary rights and those which are highly fragile).

¹⁰ See, e.g., SEC v. Infinity Grp. Co., 226 Fed. App’x 217, 218-19 (3d Cir. 2007) (“Courts of Appeals repeatedly have recognized that *pro rata* distribution of a defrauder’s assets to multiple victims of the fraud is appropriate”); SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 88-89 (2d Cir. 2002) (indicating that pro rata distributions are favored when “the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders”); SEC v. Forex Asset Mgmt. LLC, 242 F.3d 325, 331-32 (5th Cir. 2001) (citing *United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996)) (discussing how, under *Durham*, it is within a court’s equitable discretion to require pro rata distribution of funds even if tracing is possible for the majority of claims); *Durham*, 86 F.3d at 73 (finding that even when tracing is possible, it is within the equitable discretion of a court to require a pro rata distribution instead); *Liberte Capital Grp. v. Capwill*, 229 F. Supp. 2d 799, 805 (N.D. Ohio 2002) (describing that a court has discretion to fashion an equitable disbursement and when one claimant elevates “their claims by standing on the backs of the other . . . investors,” pro rata disbursement is the best choice).

¹¹ See, e.g., *Forex*, 242 F.3d at 331. The Circuit Court agreed “a pro rata distribution would provide a fair and equitable remedy.” *Id.*; see also *Quilling v. Trade Partners, Inc.*, No. 1:03-CV-236, 2007 WL 107669, at *2 (W.D. Mich. Jan. 9, 2007) (“Allowing [those two claimants] to recover from the funds seized to the exclusion of the other victims under the tracing principle would be to elevate the position of those two victims on the basis of the

Prominent critics of restitutionary tracing have basically called for a doctrine of forced sharing as a revolutionary change to orthodox restitution principles.¹² Such critics believe tracing creates “arbitrary” and “unfair” disparities between claimants, and suggest as an alternative, distributing traceable and non-traceable assets alike equally between all victims.¹³

Whether these decisions represent an answer to the call of the heterodoxy or are simply the product of the general declining awareness of restitution principles is impossible to know for certain. If “forced sharing” is a modern trend, however, and not simply an aberration, it deserves note as adding a wholly new – and somewhat radical – doctrinal scheme to American restitution law.

Part I gives an overview of tracing. It provides a context for tracing by describing the most well-known of the property-based restitution remedies, the constructive trust, for which identification of property is a prerequisite. Part I also discusses priority, one of the major benefits for obtaining property-based remedies. Finally, the mechanics of tracing as a method of identification are explored in detail, according to the three different types of identification: specific, direct tracing, and presumptive tracing.

Part II tackles the application of these basic principles to situations involving more than one claimant. First, orthodox principles are outlined briefly, followed by a thorough analysis of the Supreme Court’s landmark case dealing with multiple fraud victims – *Cunningham v. Brown*. Finally, recent cases following *Cunningham v. Brown* are explored to round out the examination of the pro rata rule as it applies in cases of multiple fraud victims.

Part III examines the “forced sharing” doctrine, beginning with critics of tracing whose arguments have suggested that such a principle be developed in the law as a replacement to orthodox tracing rules. The case law, without explicit reference to the doctrines of the critics, gives them life by enforcing a principle of forced sharing in multiple fraud victim situations where claimants are able to directly trace or specifically identify their property. Part III also seeks to formulate the principles that can be derived from the “forced sharing” cases, and to understand their implication for orthodox restitution and property principles.

A brief introduction to the terminology as it is used in this Note is warranted. The term “claimant” refers to an individual who seeks a property-based remedy in restitution.¹⁴ A “wrongdoer” is the transferee, who now holds

actions of the defrauders. The Court sees no justification in equity for this result.” (quoting *Durham*, 86 F.3d at 72)).

¹² See, e.g., Dale A. Oesterle, *Deficiencies in the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172, 191 (1983) (decrying the application of tracing principles in restitution).

¹³ See *id.* at 203-08.

¹⁴ As used in much of the literature on restitution, including the RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT (forthcoming).

the property.¹⁵ The claimant's task is to demonstrate an equitable interest in the property within the wrongdoer's possession by showing that the transfer was subject to avoidance and that the property can be identified within the wrongdoer's estate.¹⁶

The claimant's level of success may turn him into either an "owner" or a "creditor." If he can identify his property,¹⁷ he is an "owner" and so is entitled to its return.¹⁸ If all he can show is that his property went to the wrongdoer, but he is not able to presently identify it in the wrongdoer's estate, then he simply has a judgment claim against the wrongdoer, and is therefore simply a "judgment creditor." The term "creditor" is of course also used to define actual creditors – those who have lent money to the wrongdoer and are entitled, in case of insolvency, to a share in his bankrupt estate. The "priority" of owners – claimants who can identify their property in the wrongdoer's estate – over creditors in bankruptcy will also be discussed.¹⁹ Given their general equivalence in bankruptcy priority, a judgment creditor is treated as the substantial equivalent of the ordinary creditor.²⁰

"Tracing" is the method by which a claimant can identify his property in the wrongdoer's estate.²¹ There are different kinds of tracing.²² If the claimant's property is identifiable within the wrongdoer's estate, it can be "specifically identified."²³ "Direct tracing" is simply following that specifically identifiable

¹⁵ "Wrongdoer" is also used this way historically in the equity literature. *See, e.g.*, Ames, *supra* note 1, at 511 ("[H]e may enforce an equitable lien to the amount of the misappropriation upon any property in the hands of the wrongdoer, which is the traceable product of the original *trust-res.*").

¹⁶ *See generally* RESTATEMENT (THIRD) RESTITUTION & UNJUST ENRICHMENT (Tentative Draft No. 6, 2008) (describing the methods by which someone may avoid the legal effects of certain varieties of property transfers); SMITH, *supra* note 9.

¹⁷ Of course, it must already have been established that the transfer is subject to avoidance, either through fraud, mistake, etc.

¹⁸ *Third Nat'l Bank of St. Paul v. Stillwater Gas Co.*, 30 N.W. 440, 440-41 (Minn. 1886) ("So long as the property can be identified in its original or in a substituted form, it belongs to the original owner, if he elects to claim it; and, if it passes into the hands of an innocent purchaser for value, the title of the defrauded owner, at his option, at once attaches to the avails, so long as their identity is preserved, no matter how many transmutations of form the property has passed through."); *see also* PALMER, *supra* note 9, § 2.19 ("[T]he court's tracing order gave the plaintiff a preference over general creditors.").

¹⁹ *See infra* Part I.B.

²⁰ *See* ALAN N. RESNICK & HENRY J. SOMMER, *COLLIER ON BANKRUPTCY* § 548.05 (15th ed. 2007).

²¹ *See infra* Part I.A (describing how tracing functions using the example of a constructive trust).

²² *See infra* Part I.C (discussing the three ways of identifying property: specific identification, direct tracing, and presumptive tracing).

²³ *See infra* Part I.C.1.

property through successive transfers.²⁴ For example, if your specifically identifiable property is traded for other property, tracing allows you to transfer your ownership claim onto that new piece of property. What is referred to in this article as “presumptive tracing” is not actually identification at all. Presumptive tracing relies on various forms of presumptions about the nature of a commingled fund in the wrongdoer’s estate.²⁵ These presumptions are often referred to as “tracing fictions.”²⁶ In contrast, direct tracing does not rely on any of these presumptions or fictions.

I. TRACING

A. *The Constructive Trust (An Example of a Property-Based Remedy)*

Tracing is not a remedy in and of itself; it is simply a tool.²⁷ Remedies based on the restitution of specific or identifiable property, thus having identification as a prerequisite, provide a context to understand tracing. Tracing is simply a *means* of identification and arises subordinate to the remedy it serves. One such remedy is the constructive trust.²⁸

The constructive trust is only one example of what are traditionally referred to as “equitable remedies.”²⁹ Such remedies provide claimants with a means of

²⁴ See *infra* Part I.C.2. A variety of terms are used to describe what I refer to, for simplicity’s sake, as “direct” tracing. See, e.g., *In re Fin. Federated Title & Trust, Inc.*, 347 F.3d 880, 884, 888 (11th Cir. 2003) (“directly traced”); *Adams v. Moriarty*, 127 P.3d 621, 625 (Okla. Civ. App. Div. 2005) (“traced distinctly”).

²⁵ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 (Tentative Draft No. 6, 2008).

²⁶ See *id.* § 59 cmt. b.

²⁷ *Id.* § 58 cmt. a (“Tracing is neither a source of liability nor a distinct restitutionary remedy. Rather tracing is an adjunct remedial device or technique, supplementing the remedies that permit restitution from property. . . .”). But see Oesterle, *supra* note 12, at 184 (“[T]racing is viewed as a remedy. . .”).

²⁸ Other property-based remedies include subrogation, the equitable lien, and rescission. See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT §§ 54-57 (Tentative Draft No. 6, 2008). Like the constructive trust, they all require an establishment “(i) that the transaction resulting in the defendant’s unjust enrichment involved the acquisition . . . of identifiable assets, and (ii) that those assets or their product are presently identifiable in the defendant’s hands.” *Id.* ch. 7, Topic 2, introductory cmt.

²⁹ *Id.* ch. 7, Topic 2, introductory cmt. (explaining that remedies that provide “restitution via rights in identifiable property” had been “most fully developed in equity,” and therefore “often referred to as the ‘equitable remedies’ in restitution”). The forthcoming Restatement refers to these as “property-” or “asset-based” remedies. See *id.* Throughout this Note, I will use both “equitable remedies” and “property-based remedies” interchangeably. Other “property-based” remedies include rescission, the equitable lien, and subrogation. See *id.*

recovery directly tied to the property that has been lost.³⁰ Anyone “who has been deprived of his property by fraud, by theft, or by any wrongful conversion” may obtain remedy in the form of a constructive trust.³¹ A “constructive trust . . . is imposed as a remedy to prevent unjust enrichment” by “restor[ing] to the plaintiff property of which he has been unjustly deprived.”³²

Since the thief or fraudster “would be unjustly enriched if he were permitted to keep the property,” an “equitable duty to convey the property” back to the claimant “is imposed upon him.”³³ Basically, when a constructive trust is imposed, the person who has the property in his possession is deemed to hold it *for* the claimant, who is deemed to have superior title.³⁴

Thus, the constructive trust can be seen as having two main components: ownership and identification. First, to obtain any property-based remedy, there must be property in the wrongdoer’s possession over which the claimant can assert his equitable claim.³⁵ To demonstrate ownership, or to establish an equitable claim, the claimant must show that the transfer of the original property to the wrongdoer was reversible.³⁶ Thus, the wrongdoer will be unjustly enriched unless the property is returned to the claimant.³⁷ A transfer induced by fraud is a reversible transfer, subject to avoidance.³⁸ Thus, though the wrongdoer may hold legal title, the original owner still retains equitable ownership over the property.³⁹

³⁰ *Id.* (“The practical effect of these asset-based remedies is that they confer either rights of ownership or a security interest in specifically identifiable property in the hands of the defendant.”).

³¹ Ames, *supra* note 1, at 513; *see also* PALMER, *supra* note 9, § 3.4 (“Constructive trust and tracing have been made generally available to one who was induced to part with an asset through the fraud of another.”).

³² RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 160, cmts. a, d (1937).

³³ *Id.* cmts. b, c.

³⁴ *Id.* cmt. a.

³⁵ *Id.* cmt. i (“A constructive trust does not arise unless there is property on which the constructive trust can be fastened, and such property is held by the person to be charged as constructive trustee.”).

³⁶ SMITH, *supra* note 9, at 293 (explaining that a transfer of property is reversible if “made without any consent” and probably if “made under a fundamental mistake” but is not reversible if “intentional” and “informed”). Another term used for reversible is voidable. *See* Kull, *supra* note 2, at 281 (citing LORD GOFF OF CHIEVELEY & GARETH JONES, THE LAW OF RESTITUTION 68 (4th ed. 1993)).

³⁷ *See* RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 160 (1937) (indicating that when a constructive trust exists, the title holder must give the property to someone else because the title holder “would be unjustly enriched if he were permitted to retain [the property]”).

³⁸ *Id.* § 166.

³⁹ *Id.*

The claimant must not only establish a right to restitution of particular property, he must also identify the property in the hands of the wrongdoer.⁴⁰ However, the claimant is not limited to the exact property taken from him.⁴¹ He may, in addition, “charge the fraudulent vendee, the thief, or other wrongful converter as a constructive trustee of any property received in exchange for the misappropriated property.”⁴² The process whereby a claimant is able to follow his property through various forms and transactions and establish his equitable claim over it is called tracing.⁴³ Tracing is the identification of “specific property held by the debtor as a substitute of the claimant’s rightful property and thus a proper subject matter of her claim.”⁴⁴ One of the most important results of a property-based claim, such as a constructive trust, is priority.⁴⁵

⁴⁰ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT pt. III, ch. 7, topic 2, introductory note at 3 (Tentative Draft No. 6, 2008) (explaining that a restitution claimant must show that the transfer involved “identifiable assets” that “are presently identifiable in the defendant’s hands”).

⁴¹ Lionel Smith refers to the process of sticking with the exact property taken as “following” and distinguishes this process from tracing. SMITH, *supra* note 9, at 6 (defining following as “the purely physical exercise of locating a thing” and tracing as “identif[y]ing a new thing as the potential subject matter of a claim, on the basis that it is the substitute for an original thing which was itself the subject matter of a claim”). See also *id.* at 6-10, for an excellent description and comparison of both following and tracing. However, this Note, as well as the forthcoming Restatement, uses the word “follow” as synonymous to “trace.” See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (Tentative Draft No. 6, 2008).

⁴² Ames, *supra* note 1, at 513; see also *id.* at 514 (“Accordingly, the rule as to following misappropriated property into its product in the hands of the wrongdoer may be formulated as follows: If property of any kind is misappropriated in any manner by one who knows it to belong . . . to another, the true owner may charge the wrongdoer as a constructive trustee of any property in his hands which is the traceable product of the misappropriated *res*, or, if he prefers, he may enforce an equitable lien upon this traceable product to the extent of the value of the misappropriated *res*.”).

⁴³ See SMITH, *supra* note 9, at 299 (explaining that “the process of tracing is simply the proof of a series of exchanges” that “allow[s] rights to be transmitted from one asset to another”).

⁴⁴ Hanoch Dagan, *Restitution in Bankruptcy: Why All Involuntary Creditors Should Be Preferred*, 78 AM. BANKR. L.J. 247, 251 (2004).

⁴⁵ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008) (discussing priority, and explaining that “[f]requently, the most important result of the claimant’s ability to trace is the consequence for the claimant’s position vis-à-vis the recipient’s general creditors”).

B. *The Priority of Owners over Creditors*

If a constructive trust has been identified,⁴⁶ the constructive trust claimant⁴⁷ has an ownership interest in the specific property she has identified through tracing, or otherwise.⁴⁸ The nature and function of the constructive trust is to compel the wrongdoer to turn that property over to the claimant.⁴⁹

However, others may have claims on the wrongdoer's property, without sufficient assets to satisfy them all. These may range from claims in equity, to claims of various creditors. The claimant who retains a property interest in specific property has "priority" over all other claimants with regard to that property.⁵⁰ Rather than the ordering function that the word intimates, however, the principles of "priority" – at least, with regard to those having an equitable claim – is really more about the identification of the property that is actually part of the wrongdoer's estate, as opposed to the property belonging to equitable claimants.⁵¹ Since regular creditors only have a right to the actual

⁴⁶ Constructive trusts, though an equitable remedy, are more accurately described as being "recognized" rather than granted. See GEORGE GLEASON BOGERT, GEORGE TAYLOR BOGERT & AMY MORRIS HESS, *BOGERT'S TRUSTS AND TRUSTEES* § 471 (2009) ("The court must give expression to the idea that the defendant has been under an equitable duty to give the complainant the benefit of the property ever since the defendant began to hold unjustly, by holding that the defendant has since the inception been in the same position as if he had been an express trustee of the property for the complainant. To reach the result desired, the rights and duties of the parties are to be the same as if the defendant had been, from the beginning of his inequitable holding, an express trustee for the complainant. To obtain this end the court constructs a trust and makes the defendant a trustee by decree of the court for the purpose of working out justice."); Kull, *supra* note 2, at 287.

⁴⁷ Commonly referred to as the "beneficiary" – the constructive trust relationship is analogous to an actual trust. See BOGERT ET AL., *supra* note 46, § 471.

⁴⁸ See Kull, *supra* note 2, at 265.

⁴⁹ See BOGERT ET AL., *supra* note 46, § 471 ("The constructive trust may be defined as a device used by chancery to compel one who unfairly holds a property interest to convey that interest to another to whom it justly belongs.").

⁵⁰ See RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 173 cmt. j (1937) (explaining that a wrongdoer's creditors are not bona fide purchasers of the property "and are subject to the constructive trust"); see also RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008); RESTATEMENT (SECOND) OF RESTITUTION § 43 cmt. b (Tentative Draft No. 2, 1984); RESTATEMENT (SECOND) OF TRUSTS §§ 306-308 (1959) (stating that a trustee's assignee, trustee in bankruptcy, and creditor are not bona fide purchasers of the trust property).

⁵¹ See HANOCH DAGAN, *THE LAW AND ETHICS OF RESTITUTION* 297 (2004) ("Traditional doctrine grants restitution claimants in bankruptcy – creditors who can identify their property (or trace its proceeds) in the debtor's estate, and show that it was obtained as a consequence of a voidable transfer (in the typical case: of the debtor's fraud) – a valuable trump. If this restitution claimant succeeds in asserting that such an identifiable asset is subject to a constructive trust in her favor, she can simply reclaim what is deemed to be equitably hers. Thus, this fortunate claimant gets, in effect, a priority, escaping the destiny of other unsecured creditors whose claims are only partly satisfied."); Kull, *supra* note 2, at

estate of their debtor, they cannot take a share of any property belonging to another.⁵² Thus, the rule of priority serves to say that the property held in constructive trust must be taken out of the pool that is the wrongdoer's estate, because it does not belong to him, and therefore does not belong to his creditors.⁵³

Among the larger class of potential claimants (i.e., secured creditors, bona fide purchasers, etc.), principles of priority do indeed serve a complex ordering function.⁵⁴ However, as between the general classes of claimants and creditors, priority basically means claimants take what is theirs, and what remains is shared among the creditors.⁵⁵ This basic understanding of priority is all that is needed to understand the significance of a property-based claim, and thus of tracing as a means of identification.

In cases of multiple fraud victims, bankruptcy frequently plays a role.⁵⁶ Thus, there may not only be competing equitable claimants, but usually a hungry group of creditors as well. Property-based remedies, and the priority they grant, protect claimants who are able to identify the property that was taken from them, and can mean the difference between meaningful restitution and a worthless money judgment.⁵⁷

Because both direct tracing and presumptive tracing go a step beyond returning an owner's actual physical property to him or her, however, they require some further justification. Why should we recognize property rights further than the property itself? In other words, what justifies the transfer of those property rights into other property? Traditional justification sees tracing

278-79 (“[T]he claim in restitution is not (or not simply) that the debtor owes the claimant money, but that the debtor has possession and legal title of identifiable property that in equity belongs to the claimant.”).

⁵² See *Floyd v. Harding*, 69 Va. (28 Gratt.) 401, 407 (1877).

⁵³ Austin W. Scott, *The Right to Follow Money Wrongfully Mingled with Other Money*, 27 HARV. L. REV. 125, 128 (1913) (“The creditors of the wrongdoer . . . should not stand in a better position than their debtor; they should not be allowed to profit by his wrongful act. They . . . take subject to the claimant's equitable interest in the property.”).

⁵⁴ Restitution claimants' priority in bankruptcy has recently been the subject of much debate due to the waning awareness of basic principles of ownership and misunderstanding as to why the statutory codes fail to reference restitution claimants in their priority schemes. That better-known controversy is outside the scope of this Note, though concepts of “forced sharing” are certainly involved. For scholarship addressing the topic in depth, see Kull, *supra* note 2.

⁵⁵ See *id.* at 286-90 (explaining how a court must recognize a constructive trust in order to “exclude[] [the property] from the bankrupt estate”).

⁵⁶ See *id.* at 285.

⁵⁷ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT pt. III, ch. 7, topic 2, introductory note, at 3 (Tentative Draft No. 6, 2008) (describing priority as the most important advantage of property-based remedies); see also Dagan, *supra* note 44, at 251.

as an exercise in line drawing – a compromise.⁵⁸ The basic principle in bankruptcy is that creditors may only take out of the debtor’s estate.⁵⁹ Thus, what constitutes “the debtor’s estate” must be determined.⁶⁰ If ownership rights were upheld to an extreme, then any measurable enrichment of the debtor that resulted from defrauding the claimant could be considered not the debtor’s property, and therefore not subject to creditors’ claims.⁶¹ Or, creditors’ rights could be enforced to the opposite extreme, making all transfers non-voidable – abolishing property-based claims all together.⁶² Tracing rules provide a principle that meets these two approaches in the middle – it says claimants may have restitution after a voidable transfer, but only in *identifiable* property.⁶³

C. *Methods of Identification*

The restitution claimant actually might “identify” her property in one of three ways. First, she might simply be able to point out or recognize her property in the wrongdoer’s assets. Where the claimant transferred title to Blackacre as a result of the wrongdoer’s fraud, Blackacre is easily identifiable as the rightful property of the claimant. In such a case, she actually would not need to “trace” or “follow” her property beyond simply identifying it.⁶⁴

Second, the claimant might trace or follow her property into other assets, and lay a claim on the “product” of her property.⁶⁵ This time, the claimant

⁵⁸ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008).

⁵⁹ See Dagan, *supra* note 44, at 250, 257-58 (stating that when a court recognizes a constructive trust, the property identified by the claimant is excluded from the debtor’s estate and cannot be claimed by other creditors); Kull, *supra* note 2, at 286; see also RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008).

⁶⁰ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008).

⁶¹ *Id.*

⁶² *Id.* (“At the other extreme, the claim of an owner dispossessed by fraud or theft might be ranked *pari passu* with the rights of general creditors.”). Some in the bankruptcy field have in fact suggested this. See *id.* (describing those who hold this viewpoint as “argu[ing] that a ‘claim’ in restitution is like any other ‘claim’ in bankruptcy, and that informal equitable interests in property . . . are ‘anathema to the equities of bankruptcy.’”). For general background on this dispute, see Kull, *supra* note 2.

⁶³ Kull, *supra* note 2, at 282-83.

⁶⁴ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (Tentative Draft No. 6, 2008) (“[I]f A’s claim is that B obtained X from A by fraud, and A seeks specific restitution of X via constructive trust, there is no need to ‘trace’ if A can still identify X in B’s possession.”).

⁶⁵ *Id.* (“[W]hen B has already conveyed X to C in exchange for Y[, and] . . . A seeks asset-based restitution from B, A must ‘trace’ his property into B’s hands: in other words, identify Y as the traceable product of X.”).

transfers Blackacre to the wrongdoer who then sells it for cash. Proceeds of the sale identified in the wrongdoer's accounts are equally the rightful property of the claimant.⁶⁶ The claimant who is able to trace directly is effectively arguing that his ownership rights should be transferred to property that has been substituted for his property, or is the product of his property.

Third, the claimant may, through the use of tracing presumptions, claim property in the hands of the wrongdoer, which technically may or may not be her property.⁶⁷ For example, after selling Blackacre, the wrongdoer might put the proceeds into an account and then make further deposits and withdrawals, comingling the claimant's money with his own. Because the wrongdoer is responsible for the comingling, the subsequent withdrawals and deposits are "marshaled so far as possible in favor of the claimant."⁶⁸ As long as the account is never completely withdrawn,⁶⁹ equity will *presume* that the money that always remained in the account between the time the wrongdoer deposited claimant's money, and the time of the final accounting – "the lowest intermediate balance" – belongs to the claimant.⁷⁰ By using presumptive rules to trace, the claimant is making a more complicated argument. She is saying, "I can't exactly identify my property, or directly trace it, but I can prove that the money's either mine or the wrongdoer's, and you should *presume* it's mine because that's the fair thing to do as between me and him." The claimant is in effect arguing that her ownership rights should be transferred to property that is not identifiable as a substitute. It could be her property, though, and the equities of the parties support presuming so.

Historically, direct tracing has not been segregated from presumptive tracing.⁷¹ Instead, much of the literature discusses both together, and often refers to both simply as "tracing." However, "direct" tracing and presumptive tracing are actually two decidedly different processes. These differences become crucially important in the context of multiple fraud victims.⁷² One

⁶⁶ The claimant may also be able to get Blackacre itself back if the buyer had knowledge of the fraud or was complicit in it, though not if the buyer was a bona fide purchaser for value. *See id.* § 58(2) ("A claimant entitled to restitution from property or its traceable product may assert the same rights against a transferee who is not a bona fide purchaser.").

⁶⁷ *See id.* § 59 (describing how tracing rules apply to commingled funds in which a claimant's property may not be specifically identifiable).

⁶⁸ *Id.* § 59(2)(a).

⁶⁹ It should be clear that if there were a complete withdrawal in between the deposit of claimant's funds and the final accounting, then what was in the account at the end could not possibly be the claimant's. *See id.* § 59 cmt. d, ill. 11.

⁷⁰ *Id.* § 59(2)(b)-(c).

⁷¹ *See id.* pt. III, ch. 7, topic 2, introductory note at 3. The forthcoming Restatement adopts this approach. *See id.* §§ 58-59.

⁷² A lack of careful distinction between direct and presumptive tracing is a part of the recent misapplication of the holding in *Cunningham v. Brown* as discussed in Part III of this Note. *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. g, reporter's notes (Tentative Draft No. 7, 2010) (asserting that the misunderstanding of the

difference between presumptive tracing and direct tracing is that it is the imbalance in equity between the wrongdoer and the claimant that justifies the tracing presumptions. The situation changes when other claimants are involved. When the contest is between claimant and claimant, as opposed to claimant and wrongdoer, there is no longer an imbalance in equities to support a presumption. The other claimant has not been unjustly enriched. At such a point, the presumption becomes arbitrary and should no longer be enforced.⁷³ Let us explore the three methods of identification in more detail.

1. “Specific Identification” (No Tracing Necessary)

The first and simplest form of identification hardly needs explanation. It is no more and no less than the identification of the claimant’s property in the hands of the wrongdoer. A claimant might identify her property in any number of ways. In a classic example, a thief steals a rare, and clearly identifiable, painting. The claimant can easily identify her painting in the thief’s possession. In a modern case, a bank whose cash was stolen and mixed with cash belonging to other victims of the thief was able to identify and reclaim all its cash because earmarking made it identifiable as belonging to that bank.⁷⁴ In a fraud or embezzlement situation, the claimant may have turned over identifiable notes or securities.⁷⁵ Or, the wrongdoer’s bank account might have been frozen before the victim’s check cleared.⁷⁶ In all of these cases, the

holding in *Cunningham v. Brown* is partially explained by “the failure to distinguish between the ordinary transactional tracing described [as] . . . the ability to follow property into its product . . . and the orthodox presumptions that permit tracing through a commingled fund . . . where tracing would otherwise be impossible”).

⁷³ This is what *Cunningham* recognizes and holds. See *Cunningham v. Brown*, 265 U.S. 1, 12-13 (1924) (explaining that courts can presume a claimant’s money remains in a fund composed of the wrongdoer’s and a single claimant’s assets but cannot make the same presumption when the fund is composed of money fraudulently obtained from multiple claimants).

⁷⁴ *United States v. Cent. Nat’l Bank of Cleveland*, 429 F.2d 5, 6 (8th Cir. 1970). Where multiple banks are victims of robbery, one bank cannot assert priority over unmarked funds in commingled account. See *id.* at 6-7. Funds that were “marked and traceable” were returned to the owner. *Id.* at 6. The cash belonging to the other banks, in contrast, was not earmarked. *Id.* at 7. Having been combined with other cash in the pool, it became unidentifiably commingled. *Id.*

⁷⁵ Cf. *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 82-83, 88-90 (2d Cir. 2002) (upholding pro rata distribution of assets because, even though shares were identifiable, they had not “somehow been segregated in the manner of true trust accounts and/or had” not been kept from “the defrauder’s control”).

⁷⁶ Cf. *SEC v. Infinity Grp. Co.*, 226 Fed. App’x 217, 218-19 (3d Cir. 2007) (affirming pro rata distribution, even though defrauder’s bank account was frozen before it cashed claimant’s check, because “there is no equitable basis to distinguish between early investors and those . . . who invested shortly before [the] account was frozen”).

victim can clearly and unquestionably identify his property in the hands of the wrongdoer, and is entitled to its return.⁷⁷

2. “Direct” Tracing

“Direct” tracing⁷⁸ is only slightly more complex. Based on a “fundamental principle in the English common law that a change of form in a thing which is owned does not change the ownership,”⁷⁹ tracing allows a restitution claimant to “‘follow’ that property, not only through successive transfers but through successive changes of form.”⁸⁰ For example, if the claimant can show that the wrongdoer has conveyed the claimant’s property to a third party in exchange for other goods or cash, the claimant has just as much right to those goods or money as he did to the property taken from him.⁸¹ The “traceable product” of the claimant’s property could be the product of an exchange, the “increase or yield” of that property, or a combination of the claimant’s funds and other assets from which “the claimant’s property is no longer separately identifiable.”⁸²

3. Presumptive Tracing

When lawyers refer to “tracing rules,” they are usually talking about tracing presumptions.⁸³ When “indistinguishable property is combined in an undifferentiated mass or fund (as when money belonging to two people is deposited in the same bank account)” it is referred to as a “commingled fund.”⁸⁴ Tracing presumptions are rules that permit a restitution claimant to follow his property into and out of a commingled fund.⁸⁵ Since, by definition, the claimant is unable to identify his property in a commingled fund,⁸⁶ these presumptions are sometimes referred to as “tracing fictions.”⁸⁷ The

⁷⁷ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (Tentative Draft No. 6, 2008).

⁷⁸ Courts sometimes refer to “direct” tracing as “definite” or “specific” tracing; all are the same.

⁷⁹ BOGERT ET AL., *supra* note 46, § 921.

⁸⁰ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (Tentative Draft No. 6, 2008).

⁸¹ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT §§ 1-2 (Tentative Draft No. 1, 2000). This is what is referred to as “the transitivity of ownership rights.” See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. a (Tentative Draft No. 6, 2008).

⁸² RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 58 cmt. d (Tentative Draft No. 6, 2008).

⁸³ *Id.* cmt. a.

⁸⁴ *Id.* § 59 cmt. a.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* cmt. b.

Restatement (Third) of Restitution and Unjust Enrichment refers to them as “special rules to determine what part (if any) of the claimant’s property may still be identified within the commingled fund or its product.”⁸⁸

Different rules apply depending on the situation. For example, if both the wrongdoer’s and the victim’s funds simply coexist in an account, the claimant has a claim for his full loss.⁸⁹ Suppose Greg takes \$100 from Amber by fraud, and places it into his own account with \$200 of his own.⁹⁰ Amber still has a claim for her full loss, even though Greg commingled the money.⁹¹ A more complex situation is one in which the wrongdoer removes money from the account after commingling the funds. Even if Greg then spends \$200, he cannot argue he spent Amber’s money. The presumptive tracing rules dictate that any amount removed that exceeds the victim’s loss will be presumed to be that of the wrongdoer.⁹² Thus, we assume that the \$200 spent belonged to Greg, while the remaining \$100 belongs to Amber. It is as though the victim’s money has sunk to the bottom of the account and any withdrawals taken must first eliminate all of the wrongdoer’s funds before they can touch the victim’s.⁹³ Thus, by employing the presumptive rule, Amber would still have a specific claim to \$100 of the remaining money.

What if Greg withdrew \$250 and then made subsequent deposits? If Amber is using presumptive rules to trace through a commingled account, her claim is limited to the “lowest intermediate balance.”⁹⁴ That is, Amber can trace into the account to the extent of the amount of the lowest balance that existed between the point at which her money was added and the account is distributed.⁹⁵ Since that amount is \$50, Amber’s claim is limited to \$50, even if Greg later placed more money into the account.⁹⁶

⁸⁸ *Id.*

⁸⁹ *Id.* cmt. c (“The traceable product of the claimant’s assets is readily identifiable in the fund itself, or in property acquired with the whole of a commingled fund, if there are no intermediate transactions”); see also Peter B. Oh, *Tracing*, 80 TUL. L. REV. 849, 885 (2006).

⁹⁰ This example is based on RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. c, illus. 1 (Tentative Draft No. 6, 2008).

⁹¹ *Id.* § 59(1)(a).

⁹² See Palmer, *supra* note 9, § 3.4; see also RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59(2)(a) (Tentative Draft No. 6, 2008).

⁹³ See James Steven Rogers, *Negotiability, Property, and Identity*, 12 CARDOZO L. REV. 471, 499 (1990) (explaining the tracing rules as treating commingled funds analogously to mixing water (the victim’s assets) with oil (the wrongdoer’s assets)).

⁹⁴ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59(2)(c) & cmt. d (Tentative Draft No. 6, 2008).

⁹⁵ *Id.*

⁹⁶ *Id.* For further examples of how the “lowest intermediate balance” rule works in various cases, see *id.* cmt. d, illus. 4-13.

II. MULTIPLE CLAIMANT SITUATIONS

A. *Identification of Property Among, Between, and by Multiple Restitution Claimants*

So far, we have only considered situations with a single claimant. The same rules of tracing apply when there are multiple claimants.⁹⁷ As noted earlier, the dynamics have now been slightly altered. Whereas before it was claimant versus wrongdoer, when there are multiple claimants with claims on a deficient wrongdoer's estate, suddenly it seems to be claimant versus claimant. As long as any claimant *is able to identify his property*, however, it is simply a matter of applying the rules already discussed.⁹⁸ The process gets more complicated when dealing with commingled funds. If more than one claimant's property has been commingled, and none can definitely show that their money remains, each must share in proportion to their traceable loss.⁹⁹ Because they are able to trace into the commingled assets, they will still receive priority over creditors with respect to the traced property.

To illustrate how these rules play out, let's say Greg ran a Ponzi scheme and ended up taking money from a few people: \$100 from Amber, \$150 from Brian, and \$200 from Celeste. Afterwards, Amber can prove that \$50 of her money was used to purchase an iPod, and Greg placed the rest in his account. Brian can prove that his \$150 was placed in a safety deposit box and left there. Celeste, however, is unable to show what happened to her money, but she can establish that it was also placed into Greg's account. There is only \$100 left in that account. Brian should get all of his \$150 returned to him, since he is able to identify it as his own. Amber gets the iPod, since she can trace her money into its purchase. She also has a remaining priority claim for \$50. Celeste has a priority claim for her \$200. Assuming there are no other claimants, Amber and Celeste will share the remaining \$100 in proportion to their claims; \$20 for Amber, and \$80 for Celeste.

Such a simple multiple fraud victim case is easier to imagine than to find in real life.¹⁰⁰ Nonetheless, it serves as a good starting point to lay down some

⁹⁷ See RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS §§ 213-214 (1937) (describing the rules for situations where funds contain money of multiple claimants or things other than money); see also RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT §§ 58-59 (Tentative Draft No. 6, 2008).

⁹⁸ See RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 213 (1937) ("Where the wrongdoer has effectively separated the money of one of the claimants, that claimant is entitled to, and only to, his own money or its product."). The same principle applies where the wrongdoer has commingled property other than money. *Id.* § 214.

⁹⁹ *Id.* § 213.

¹⁰⁰ Even where there are only two claimants, tracing property through all of the wrongdoer's investments can become very complicated. For a case in which one party was able to successfully do so and was therefore granted a constructive trust over property in another victim's possession, see *Lyons v. Jefferson Bank & Trust*, 994 F.2d 716 (10th Cir. 1993).

basic principles. Note that Brian has made a full recovery, while Amber is slightly worse off, recovering 70% of her loss. Celeste's situation is much worse – she has only recovered 40% of her loss. Of course, Amber and Celeste still have claims for the remainder of their losses, along with any other unsecured creditors, but those are probably worthless. Any disparity between claimants, however, is simply the result of the court giving back the identifiable assets to their owners, and dividing up what is left. If some claimants “made out” better than others, that is because they could trace and the others could not. The results are based entirely on the fact that the parties experienced different losses as a result of the wrongdoer's conduct.¹⁰¹

B. *Where No Claimants Are Able to Directly Trace or Identify: Pro Rata Rule, Presumptions Suspended*

1. The Supreme Court and the First Ponzi: *Cunningham v. Brown*

*Cunningham v. Brown*¹⁰² involved the bankruptcy of one of the biggest swindlers in American history, Charles Ponzi.¹⁰³ Ponzi, in a sham pyramid scheme, “borrowed millions of dollars in small amounts from many persons, all of whom were defrauded in the same manner.”¹⁰⁴ After word got around that Ponzi was bankrupt, a number of his more recent victims claimed preference to money in one of his bank accounts.¹⁰⁵ The lower courts agreed with the claimants that their deposits were rescindable on the grounds of fraud, and that each of these particular claimants “were entitled to the return of their money.”¹⁰⁶ These courts were applying

the presumption . . . that a wrongdoing trustee first withdrew his own money from a fund mingled with that of his *cestui que trustent*, and therefore that the respective deposits of the defendants were still in the bank and available for return to them in rescission; and that payments to

¹⁰¹ However unfortunate, disparity in ultimate outcomes among victims of a wrongdoer is actually quite normal; think of a tortfeasor who pollutes his neighbors' property – as a result of pure chance or the wrongdoer's choices, some may lose millions of dollars, while others may only experience minimal damages. Nonetheless, certain courts have tried to correct such disparities by imposing liabilities on the more fortunate, but also wholly innocent, victims of the wrongdoer. See *infra* Part III.B-C.

¹⁰² 265 U.S. 1 (1924).

¹⁰³ *Id.* at 7.

¹⁰⁴ See PALMER, *supra* note 9, § 3.4, at 239.

¹⁰⁵ *Cunningham*, 265 U.S. at 10-11 (“On the morning . . . when news of Ponzi's insolvency was broadly announced, there was a scramble and a race.”).

¹⁰⁶ *Id.* at 9.

them of these amounts were not preferences, but merely the return of their own money.¹⁰⁷

The Supreme Court, however, saw the case differently.¹⁰⁸ Because Ponzi had been declared a bankrupt before his victims' claims arose, the Court identified these claims as within the general pool of creditors – including other victims – with claims to the funds.¹⁰⁹ Applying orthodox restitution principles, the Court deemed that the only way the claimants could achieve preference was if they were able to establish the existence of a constructive trust or equitable lien.¹¹⁰ To do so, the claimants were of course required to directly trace their money into – and out of – the seized bank account successfully. The account, however, consisted of indistinguishably commingled funds.¹¹¹ Furthermore, the funds were commingled with funds from Ponzi's other victims, and not simply with the wrongdoer's own money.¹¹² Thus, the use of a presumption to permit the claimants to trace was improper.

The “presumption that the wrongdoer first withdrew his own funds from a commingled fund”¹¹³ and that what is left belongs to the claimant would be appropriate to apply to claims solely between a restitution claimant and a wrongdoer. And through the presumption, such a claimant could satisfy his tracing burden.¹¹⁴ In *Cunningham*, however, all the funds belonged, not to the wrongdoer, but to other claimants. Thus, to apply the presumption would be to give the more recent victims an artificial priority over Ponzi's other victims, whose money at one point also went into that account.

Such a priority would be artificial because the claimants in the case, just like Ponzi's other victims, were unable to directly trace their money.¹¹⁵ Since applying the presumption in this case would work in favor of those victims at the expense of other victims, the Court found that to do so would be inappropriate.¹¹⁶ To presume that the money was theirs would be to favor these particular claimants simply because they had gotten to court first – an

¹⁰⁷ *Id.* This is the “marshalling” rule described in RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 (Tentative Draft No. 6, 2008). See also *supra* notes 68-70 and accompanying text.

¹⁰⁸ *Cunningham*, 265 U.S. at 9.

¹⁰⁹ *Id.* at 13.

¹¹⁰ *Id.* at 11 (stating that, by establishing a constructive trust or equitable lien, the victims would have sought to claim their own money and not that of the bankrupt estate).

¹¹¹ *Id.*

¹¹² *Id.* at 13.

¹¹³ PALMER, *supra* note 9, § 3.4, at 239.

¹¹⁴ *Cunningham*, 265 U.S. at 13.

¹¹⁵ *Id.*

¹¹⁶ See *id.* (“To say that, as between equally innocent victims, the wrongdoer, having defeasible title to the whole fund, must be presumed to have distinguished in advance between the money of those who were about to rescind and those who were not, would be carrying the fiction to a fantastic conclusion.”).

arbitrary distinction, not an equitable one. Instead, since none of the claimants could directly trace their money, the Court decreed that all the victims should share in the fund ratably, each in proportion to his own loss.¹¹⁷

Had the plaintiffs been able to trace their money without the use of presumptions, the typical restitution property-based remedies would have been available to them.¹¹⁸ As Chief Justice Taft explained, the plaintiffs

could have followed the money wherever they could trace it and have asserted possession of it on the ground that there was a resulting trust in their favor, or they could have established a lien for what was due them in any particular fund of which he had made it a part.¹¹⁹

Unfortunately, “to succeed they [had to] trace the money and therein they have failed.”¹²⁰ Because it was “impossible to trace [the money] into the . . . deposit . . . from which defendants’ checks were paid,” they were unable to identify their property or its proceeds.¹²¹ Thus, there was nothing “upon which a constructive trust, or an equitable lien could be fastened.”¹²²

Cunningham’s holding created a new rule: The use of tracing presumptions cannot be justified (and must therefore be suspended) when the parties fighting over unidentifiable, commingled property are all victims of the same fraud, *and none of them can directly trace or identify their property*.¹²³ In such a case, the money or other property is to be distributed pro rata among those who can show their money went into the account, but are unable to satisfy the tracing burden without the use of presumptions.¹²⁴

In addition, *Cunningham*’s dictum reiterated a couple of basic restitution principles. First, *Cunningham* endorsed the view that if a victim *could* directly trace or identify his property, then that victim would be entitled to the recovery of his property through the use of a constructive trust or equitable lien, even though there might be other victims.¹²⁵ Second, the Supreme Court acknowledged that tracing presumptions, despite being fictitious, still have a role when the dispute is between a wrongdoer and a victim.¹²⁶ The justifications relating to the differing degrees of equity between the parties that would otherwise support such presumptions, fail only when the dispute over the property is “between equally innocent victims.”¹²⁷

¹¹⁷ *Id.* at 12.

¹¹⁸ *Id.* at 11.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.* at 13.

¹²⁴ *Id.*

¹²⁵ *Id.* at 11.

¹²⁶ *Id.* at 13.

¹²⁷ *Id.*

“Equality [was] equity” in *Cunningham* because all the victims were similarly situated.¹²⁸ But they were similarly situated as a result of their inability to trace their money, *not* because they were all victims.¹²⁹ Though the Court used the language “equally innocent victims,” it only grouped together all the victims in the case because they were all the same in their “inability to identify their payments.”¹³⁰ The Court separated from its holding any parties that hypothetically could have traced or identified their funds.¹³¹

Even if *Cunningham*’s dicta did not specifically allow for tracing in multiple fraud victim situations, it is a logical deduction. Because parties who could directly trace or identify assets over which they have proprietary claims have no need of presumptions, a holding suspending the use of such presumptions in all circumstances could not affect them. Or at least, it would not appear so.

2. Subsequent Decisions in Lower Courts

As is to be expected, especially with large schemes of the Ponzi variety, in many cases, all of the property taken by the fraudster has been indistinguishably commingled. Occasionally, however, multiple fraud victims come forward as restitution claimants, and some, but not all, are able to trace their money or property. As this is the situation envisioned by, but not occurring in, *Cunningham*, many courts follow *Cunningham*’s dicta with regard to the traceable assets. These courts use various adjectives – “direct,” “definite,” “distinct,” or “specific” – and in this way keep clear, as did *Cunningham*, the difference between direct and presumptive tracing.¹³² The *Cunningham* rule says that when “[i]t is certain that the commingled fund represents an inextricable compound that no alchemist would dare the attempt to unscramble,” only then should all the claimants “bear the losses and participate in the distribution of the total assets on a pro rata basis.”¹³³ This is often referred to as the pro rata rule for Ponzi schemes: “[I]n the case of a Ponzi scheme, remaining assets must be distributed to victims on a pro-rata basis *unless* a particular [claimant’s] assets are able to be specifically traced.”¹³⁴ If the fraudster has “commingled the funds of various investors in a

¹²⁸ *Id.* (characterizing all the victims who were unable to identify their payments as creditors).

¹²⁹ *Id.*

¹³⁰ *Id.* (“They were all of one class [T]hey were, *in their inability to identify their payments*, creditors and nothing more.” (emphasis added)).

¹³¹ *See id.* at 12.

¹³² *See, e.g.,* *Crestar Bank v. Williams*, 462 S.E.2d 333, 335 (Va. 1995) (“[T]o be entitled to the benefit of a constructive trust, a claimant’s money must be ‘distinctly traced’ into the chose in action, fund, or other property which is to be made the subject of the trust.” (quoting *Watts v. Newberry*, 57 S.E. 657, 659 (Va. 1907))).

¹³³ *First State Trust & Sav. Bank v. Therrell*, 138 So. 733, 738 (Fla. 1932).

¹³⁴ *Adams v. Moriarty*, 127 P.3d 621, 624 (Okla. Civ. App. 2005) (emphasis added).

single account, those assets lose their character as the peculiar assets of their investor.”¹³⁵

If, however, “claimants *were* able to trace the funds . . . then those claimants ‘would have been endeavoring to get their own money, and not money in the estate of the bankrupt.’”¹³⁶ This is because “where fraudulently obtained assets are held by the debtor but are readily distinguishable from assets to which general creditors have a claim, it is proper to return the property to the defrauded party rather than distribute it through the estate.”¹³⁷ In *Cunningham* itself, “funds [the wrongdoer] obtained by fraud were property of the estate [only] because it was *impossible* for the many victims of the fraud to trace what had become of their payments and the funds held were insufficient to pay all potential claimants.”¹³⁸

The “pro rata rule” does not overrule orthodox tracing doctrine. It is still the case that “a person who wishes to establish a constructive trust on money must trace the money from the hands of the defrauded person to the fund over which he seeks to impose the trust.”¹³⁹ Ratable distribution among multiple fraud victims is appropriate, however, when the funds of all the claimants have become indistinguishably commingled and none of them are able to trace or identify their property.¹⁴⁰ Though *Cunningham* spoke to this issue specifically and was a Supreme Court decision, it did not create any new doctrine. In fact, state courts had determined that pro rata distribution of unidentifiably commingled trust property should be divided this way long before *Cunningham*.¹⁴¹

However, as this Note will explore, *Cunningham* is not uniformly interpreted in this fashion. Certain courts have taken what some refer to as a “broad reading” of *Cunningham* and propelled the “pro rata” rule to the extreme, applying it where it seems *Cunningham* said not to – to parties who can specifically identify or trace their property.¹⁴² It is not clear whether this is a purposeful development based on dissatisfaction with the current rules, or simply an unintended departure from *Cunningham* and restitution principles generally.

¹³⁵ *Id.*

¹³⁶ *Id.* (quoting *Cunningham*, 265 U.S. at 11) (emphasis added).

¹³⁷ *In re M&L Bus. Mach. Co.*, 59 F.3d 1078, 1081 (10th Cir. 1995).

¹³⁸ *In re M&L Bus. Mach. Co.*, 164 B.R. 148, 151 (D. Colo. 1994) (emphasis added) (describing *Cunningham*), *aff’d M&L*, 59 F.3d 1078.

¹³⁹ *Brown v. Coleman*, 566 A.2d 1091, 1099 (Md. 1989).

¹⁴⁰ *See, e.g., Cunningham*, 265 U.S. at 13.

¹⁴¹ *See, e.g., Thompson v. Shaw*, 71 A. 370, 373 (Me. 1908).

¹⁴² *See infra* Part III.B (examining cases in which victims were able to trace their money yet received a pro rata share of the assets).

III. THE HETERODOXY

A. *Tracing's Critics*

Despite its intuitive appeal, tracing is not without its critics.¹⁴³ Professor Dale Oesterle, for one, decries tracing law as founded on “arbitrary presumptions,” and resulting in unfair treatment of differently situated claimants, which Oesterle would characterize as “similarly situated.”¹⁴⁴ As we have seen, in a case between two victims of a wrongdoer, the one whose property has been held separately, or has been converted into property that remains in the wrongdoer’s possession, receives a full remedy, while the one whose property has been converted into cash, and spent, is left with only a money judgment, which may be worthless if no property secures it.¹⁴⁵ Oesterle considers the disparate treatment of victims who might be able to trace, and those who cannot, to be inequitable.¹⁴⁶

Oesterle considers tracing to be justified solely by a presumption of causality, and thereby illogical.¹⁴⁷ In Oesterle’s view, tracing depends on the assumption that the wrongdoer would not have the property but for the wrongful act.¹⁴⁸ In other words, what justifies tracing into the iPod in Amber’s case,¹⁴⁹ is that but for the money taken from Amber, Greg could not have purchased it. But, as Oesterle points out, there is just as much “causal” likelihood of the iPod being the but-for result of the property taken from another.¹⁵⁰ To continue Oesterle’s analysis in our own example, if Greg had not taken Celeste’s money, he would have used the money that he spent for the iPod on his other expenses. Thus, if causation is our only focus, tracing does indeed seem arbitrary.¹⁵¹ There is just as much reason, based on causal justifications, to give the iPod to Celeste, as to Amber.

¹⁴³ See Oesterle, *supra* note 12, at 191.

¹⁴⁴ See *id.* at 203-08 (discussing “tracing’s arbitrary distinctions between claimants”).

¹⁴⁵ *Id.* at 203-04.

¹⁴⁶ *Id.* at 205.

¹⁴⁷ *Id.* at 199 (“Tracing cuts off such an inquiry [into whether the Wrongdoer would have otherwise made the conversion] by conclusively presuming that Wrongdoer would not have acquired the hat absent the conversion. . . . [In certain cases] the presumption is irrational.”).

¹⁴⁸ *Id.*

¹⁴⁹ See *supra* notes 97-101 and accompanying text.

¹⁵⁰ Oesterle, *supra* note 12, at 204-05.

¹⁵¹ *But see* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 cmt. b (Tentative Draft No. 6, 2008) (“[Tracing] rules will indeed appear fictional if they are explained . . . as presumptions about the intent of the [wrongdoer] [H]owever, the tracing rules have nothing to do with anyone’s intent. . . . [They] are not arbitrary: they make a rough, practical compromise between the competing interests of the restitution claimant and of the other persons with an interest in the fund. The balance initially struck by the tracing rules is graduated, moreover, to reflect the equitable position of the persons at whose expense restitution is awarded.” (citation omitted)).

Oesterle also points out that the “inequity of treatment . . . appears particularly harsh” when the owner who can trace has a claim to property that is worth more than the property he lost, while the owner who cannot trace is not entitled to any portion of that property.¹⁵² Say Greg used Amber’s whole \$100 to purchase a bond. When the bond is returned to Amber’s possession, it is worth \$150. Where the only parties involved are the victim and the wrongdoer, the claimant victim is entitled to the proceeds of the invested funds – all of them – despite the fact that her return is greater than her loss.¹⁵³ This is because the underlying foundation of the recovery is that the wrongdoer has been unjustly enriched, and to remove his unjust enrichment the entire product of the embezzlement must be removed from him and returned to the original owner.¹⁵⁴

However, what if there is no money left in Greg’s account? As Oesterle imagines it, Amber is entitled to the whole \$150 bond, since the extra \$50 in value is the product of her property, while Celeste, another victim who cannot trace, is left with a worthless money judgment.¹⁵⁵ In fact, tracing doctrine limits profitable tracing recovery when it would result in the unfair treatment of an innocent third party, rather than simply the removal of unjust enrichment of the wrongdoer. Oesterle himself concedes this.¹⁵⁶ Moreover, profitable recoveries are infrequent. Thus, though the imagined scenario is great fodder for a tracing critic’s outrage, it is unlikely to occur in real life. Most tracing critics’ true concern is that through tracing, certain claimants might recover more than other claimants do, because they can trace.¹⁵⁷ Oesterle remains unsatisfied with the orthodox approach because it fails to ensure that each victim’s recovery be the same.¹⁵⁸

¹⁵² See Oesterle, *supra* note 12, at 205.

¹⁵³ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 3 cmt. b. (Discussion Draft, 2000) (providing that restitution requires “full disgorgement of profits” even if it exceeds the injury to the plaintiff or the value of a “license authorizing the defendant’s conduct”); RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 51 cmt. e (Tentative Draft No. 5, 2007).

¹⁵⁴ RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 3 cmt. a (Discussion Draft 2000) (“Any profit realized in consequence of intentional wrongdoing is unjust enrichment because it results from a wrong to the plaintiff.”).

¹⁵⁵ See Oesterle, *supra* note 12, at 205 (hypothesizing that “Owner-One has an *in specie* claim on the guitar through constructive trust, while Owner-Two has only a money judgment”).

¹⁵⁶ *Id.* at 194 (acknowledging that “[m]odern commentators [of tracing law] . . . would limit the beneficiary’s recovery to his actual loss” rather than the full windfall value, when the dispute is between innocent parties). The forthcoming Restatement explicitly adopts this approach. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 61 (Tentative Draft No. 7, 2010) (“When . . . the evidence does not suffice to distinguish the interests of competing claimants, the claimants recover ratably from the assets so identified.”).

¹⁵⁷ See Oesterle, *supra* note 12, at 205.

¹⁵⁸ *Id.*

Rather than following the different property through its various changes in forms, Oesterle would have the courts employ causally based theories of property recovery, resulting in what he considers to be more equitable results.¹⁵⁹ To compare Oesterle's approach with orthodox tracing doctrine, consider Oesterle's own hypothetical, in which "Wrongdoer converts two silver teapots, each valued at \$100 and owned by Owner-One and Owner-Two respectively."¹⁶⁰ Subsequently, "Wrongdoer exchanges Owner-One's teapot for a guitar and Owner-Two's teapot for wine, which Wrongdoer consumes."¹⁶¹

In such a case, only "Owner-One" is able to trace his property into the guitar. Thus, under an application of standard tracing, Owner-One will be able to obtain a full property-based recovery of the guitar. Owner-Two, however, will be left with the less optimal recovery of a claim for a money judgment.¹⁶² Oesterle suggests that a "better result" is one in which "Owner-One and Owner-Two split the value of the guitar."¹⁶³ If Owner-Two is able to prove that his teapot enabled the purchase of the guitar, he should be entitled to an equal share in the value of the guitar.¹⁶⁴ Even where Owner-Two cannot prove such causality, Oesterle suggests courts apply "a presumption that the teapots of *both* Owner-One and Owner-Two, if stolen within a fixed period of the Wrongdoer's acquisition of the guitar, enabled Wrongdoer to acquire the guitar."¹⁶⁵

Let us apply Oesterle's approach to our first multiple fraud victim scenario¹⁶⁶ in which the following sequence of transactions occurred: Half of Amber's \$100 has been spent to purchase an iPod. All of Brian's \$150 has been set aside and remains separate. Celeste's money has been commingled, but she can prove it went into Greg's bank account. And let us add a fourth victim, Danny. Danny was a victim of Greg's fraud and lost \$50. However, he cannot trace at all. That is, he cannot prove that his money ever went into Greg's remaining bank account, which now holds \$100. Oesterle would have the court pool the remaining assets, including Amber and Brian's property, for

¹⁵⁹ *See id.* at 204, 206 (suggesting that courts presume that the thief's gain from the theft and conversion of the property owner who can trace was also in part the result of his theft of the property owner who cannot).

¹⁶⁰ *Id.* at 203.

¹⁶¹ *Id.*

¹⁶² A claim for a money judgment will be even more undesirable if Wrongdoer happens to be bankrupt. *See id.* at 203-04 (recognizing that if "Wrongdoer's only asset is the guitar" then Owner-One, who can trace his property to the guitar "recovers all of Wrongdoer's tangible assets, and Owner-Two recovers nothing").

¹⁶³ *Id.* at 204.

¹⁶⁴ *Id.* at 205 ("If the guitar is worth more than both teapots, Owner-One and Owner-Two would enjoy a division of the gain.").

¹⁶⁵ *Id.* at 204-05.

¹⁶⁶ *See supra* notes 97-101, 149-61 and accompanying text.

a total seizure of \$300.¹⁶⁷ Oesterle would then have the \$300 distributed between all of Greg's victims, including Danny, in pro rata proportions.¹⁶⁸

Note that what will have occurred, what Oesterle demands, is a redistribution of what was identifiable as Amber's and Brian's property to victims with claims of lesser value or no claim at all.¹⁶⁹ It is sufficient, in Oesterle's view, that they were all victims of Greg's fraud. Since all lost as a result of Greg's fraud, all should be treated the same. Oesterle's approach requires completely ignoring the ownership rights of the claimants. It does not matter that Amber can follow her property into the iPod, or that Brian can identify his cash in the safety deposit box. They must share, since Greg's fraud affected other victims as well.

Another critic of tracing, James Steven Rogers, disagrees that tracing is "based on causal notions."¹⁷⁰ He points out that Oesterle's argument regarding tracing's causal absurdity goes too far and if carried logically would prevent the return of an owner's own uncontroverted piece of property.¹⁷¹ Instead, Rogers insists "tracing rules in general . . . rest on some form of assertion that the traceable product can aptly be described as the 'same thing' as the original property."¹⁷² It is from this position that he attacks tracing presumptions as being "absurd."¹⁷³

Tracing presumptions, Rogers contends, "are perhaps the most elaborate and detailed attempt anywhere in our legal system to retain the normative consequences of mine versus thine even though the objects of these property concepts have irretrievably lost their identifiable thingness."¹⁷⁴ In particular, Rogers is unsatisfied with the line at which the compromise between owners and creditors was drawn.¹⁷⁵ He believes the line should be pulled back to before the first transfer or transmutation of property has occurred.¹⁷⁶ Rogers

¹⁶⁷ \$50 (iPod) + \$150 (safe deposit) + \$100 (Greg's account) = \$300

¹⁶⁸ Amber would receive \$60; Brian, \$90; Celeste, \$120; and Danny, \$30.

¹⁶⁹ That is, no claim of equal priority. With the orthodox approach, Danny would have no restitution claim to the remaining cash in the bank account, because he could not trace.

¹⁷⁰ Rogers, *supra* note 93, at 500.

¹⁷¹ *See id.* at 493. If Greg had stolen two identical iPods, one from Amber and the other from Celeste, and sold one of the iPods to buy lunch for his friends, then one could argue that Amber is not entitled to the return of her iPod if causality is the rule. But for Celeste's iPod, hers was sold and the product consumed.

¹⁷² *Id.* at 500.

¹⁷³ *Id.* at 499.

¹⁷⁴ *Id.* at 501.

¹⁷⁵ *See* discussion *supra* Part I.B; *see also* RESTATEMENT (THIRD) RESTITUTION & UNJUST ENRICHMENT § 58 cmt. b (Tentative Draft No. 6, 2008) ("The . . . owner . . . recovers in priority to general creditors, but only to the extent that the creditors would otherwise be unjustly enriched at the owner's expense.").

¹⁷⁶ Rogers, *supra* note 93, at 500-01 ("If we take the question seriously, we end up . . . with . . . a very imprecise sense that one can trace into a commingled account only if there haven't been 'too many' subsequent transactions.").

goes on to suggest that traditional ideas about property transfers should not apply at all to securities.¹⁷⁷

B. *Pro Rata Extremists*

Despite *Cunningham's* seemingly clear distinction between the use of tracing presumptions and "definite tracing" or identification, a number of recent decisions involving claimants who *were able* to identify or "definitely trace" their assets (without the use of tracing presumptions), nonetheless enforced a pro rata share of those claimants' assets. In *United States v. Durham*, the FBI seized an account belonging to a group of defendants who were later convicted of "wire fraud, money laundering, and conducting financial transactions with money derived from unlawful activity."¹⁷⁸ The seized account held roughly \$83,000.¹⁷⁹ The defendants had victimized a total of thirteen different parties.¹⁸⁰ Only four of the claimants, however, were able to trace into the remaining funds.¹⁸¹ Approximately \$71,000 of the funds could be directly traced to one of the four, a company called Claremont Properties.¹⁸² Rather than granting Claremont and the other victims the amount of money traceable to them, the district court decided to award a pro rata share to each victim.¹⁸³ According to the pro rata formula, Claremont was awarded less than \$17,000.¹⁸⁴ The Fifth Circuit affirmed the decision, stating:

[A]ll claimants stand equal in terms of being victimized by the defendant defrauders. The ability to trace the seized funds to Claremont . . . is the result of the merely fortuitous fact that the defrauders spent the money of the other victims first. Allowing Claremont . . . to recover from the funds seized to the exclusion of the other victims under the tracing principle would be to elevate the position of [this] victim[] on the basis of the actions of the defrauders. The Court sees no justification in equity for this result.¹⁸⁵

In *SEC v. Forex Asset Management LLC*, the Whitbecks, a married couple, invested a total of \$900,000 in what turned out to be a fraudulent investment scheme.¹⁸⁶ Their first \$100,000 investment was commingled with the funds of other investors.¹⁸⁷ Their second investment of \$800,000, however, was held in

¹⁷⁷ *Id.* at 506-08.

¹⁷⁸ *United States v. Durham*, 86 F.3d 70, 71 (5th Cir. 1996).

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 72.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *SEC v. Forex Asset Mgmt. LLC*, 242 F.3d 325, 327 (5th Cir. 2001).

¹⁸⁷ *Id.* at 328.

a separate account.¹⁸⁸ That account remained separate and intact until the fraud was discovered, and the Whitbecks sued for the return of their funds.

Even though their \$800,000 had been held in a separate account, and could therefore be directly identified as their money, the district court refused to grant the Whitbecks' claim for its return.¹⁸⁹ Rather, the court agreed with the Receiver responsible for the distribution of Forex's assets who felt that "the assets should be distributed on a pro rata basis in order to treat the creditors equally."¹⁹⁰ The Fifth Circuit affirmed over the Whitbecks' strong arguments for a constructive trust over the funds.¹⁹¹ It permitted the district court's reliance on *Durham*, agreeing that a pro rata distribution of the funds between all the creditors presented a "fair and equitable remedy."¹⁹² The Whitbecks ended up being awarded less than a third of the amount they were able to positively identify as belonging to them.¹⁹³

In *SEC v. Credit Bancorp, Ltd.*, Credit Bancorp, Ltd. ("CBL") ran a "classic Ponzi scheme"¹⁹⁴ by which hundreds of investors were defrauded of their assets.¹⁹⁵ Many of the investors had simply transferred cash to CBL.¹⁹⁶ However, one of the investors, SECO, had transferred eight million "Vintage Petroleum" shares to CBL.¹⁹⁷ When the fraud was discovered, the shares remained in an account and could be separately identified.¹⁹⁸ SECO argued that the shares, transferred under fraud, were held for them in constructive trust.¹⁹⁹ But the Second Circuit affirmed the lower court's authority to administer a pro rata distribution of all the assets held by CBL, including SECO's identifiable shares.²⁰⁰

The Second Circuit acknowledged that "[u]nder state law, assets acquired by fraud are subject to a constructive trust for the benefit of the defrauded party."²⁰¹ Nonetheless, the court seemingly dismissed (as irrelevant) the

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 332.

¹⁹⁰ *Id.* at 328.

¹⁹¹ *Id.* at 331-32.

¹⁹² *Id.* at 331. The Fifth Circuit largely set aside the Whitbecks' attempts to distinguish *Durham* from their case in that their case did not require tracing (they could simply identify the funds as belonging to them) calling it "a distinction without a difference." *Id.*

¹⁹³ The pro rata formula gave them an approximate thirty-three percent share in the remaining \$777,372. *Id.* at 328, 331.

¹⁹⁴ *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 83 (2d Cir. 2002).

¹⁹⁵ *Id.* at 84.

¹⁹⁶ *Id.* at 84, 85.

¹⁹⁷ *Id.* at 88.

¹⁹⁸ *Id.* at 85.

¹⁹⁹ *Id.* at 88.

²⁰⁰ *Id.*

²⁰¹ *Id.* (citing RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 166 (1937)).

existence of such a constructive trust, stating that “[i]n any event, whatever beneficial interest SECO might have in the transferred shares, arising from a constructive trust, does not defeat the equitable authority of the District Court to treat all the fraud victims alike (in proportion to their investments) and order a *pro rata* distribution.”²⁰²

The court then cited a string of cases, beginning with *Cunningham*, for the proposition that “the use of a *pro rata* distribution has been deemed especially appropriate for fraud victims of a ‘Ponzi scheme.’”²⁰³ The discussion was notably devoid of any of *Cunningham*’s actual language. It was as if the distinction had never been made between parties who were able to definitely trace or identify their property and those who could only do so with the use of tracing presumptions.

Despite what one might imagine, *Durham*, *Forex*, and *Credit Bancorp* are not outliers. This unorthodox treatment of tracing in the context of multiple fraud victims occurs in more than a dozen recent cases in various jurisdictions.²⁰⁴ Many of these, even those outside the Fifth Circuit, cite to *Durham* or *Forex* as persuasive precedent on *Cunningham*’s application.²⁰⁵ The doctrine of these cases appears to contain at least two important tenets. First, they seem to imply, and many say explicitly, that restitution law, including the rules of tracing, is purely optional or discretionary.²⁰⁶ Second, where there are multiple victims of a fraud, it is within the courts discretion to

²⁰² *Id.*

²⁰³ *Id.* at 89 (citing four cases, including *Cunningham v. Brown*, 265 U.S. 1, 11 (1924), supporting the applicability of the pro rata distribution of a Ponzi schemer’s assets). This is true, but only up to a point. Since most Ponzi cases are ones like the original, in which no claimant can trace, a pro rata distribution is appropriate. However, the case at bar, despite involving a Ponzi scheme, was distinguishable.

²⁰⁴ See, e.g., *SEC v. Infinity Grp. Co.*, 226 F. App’x. 217, 218 (3d Cir. 2007) (holding return of funds is improper where a late investor in a fraudulent scheme can trace his money in account because check on hold for two days during which defrauder’s accounts were frozen; rather, the investor must share ratably with all other fraud victims); *Liberte Capital Grp. v. Capwill*, 229 F. Supp. 2d 799, 804-05 (N.D. Ohio 2002) (explaining that though the claimant’s funds are separately identifiable, other claimants are victims too, so pro rata recovery was available regardless).

²⁰⁵ See, e.g., *Liberte Capital Grp.*, 229 F. Supp. 2d at 803 (“Other courts faced with situations where tracing for some but not all parties was possible have employed a *pro rata* approach.”).

²⁰⁶ See *Quilling v. Trade Partners, Inc.*, No. 1:03-CV-236, 2007 WL 107669, at *2 (W.D. Mich. Jan. 9, 2007) (“It is well within the district court’s discretion to reject equitable principles of tracing, restitution, reclamation, etc. and order a *pro rata* distribution to treat all defrauded investors equally in proportion to their losses.”). For a discussion of why courts should not invoke these rules on an entirely discretionary basis, see *infra* notes 219-24 and accompanying text.

disallow tracing, even when a claimant can identify or directly trace his or her property.²⁰⁷

This transforms *Cunningham*'s holding from a suspension of tracing presumptions where there are multiple victims *and* no parties are able to directly trace or identify to a suspension of tracing presumptions, direct tracing, and identification of property *whenever* there are multiple victims. These cases, however, never seem to acknowledge a difference between definite tracing (or even actual identification) and tracing presumptions (which could rightfully be called fictions). They just generally disclaim "principles of tracing" or "tracing fictions" while disallowing whole recovery to a claimant who can positively identify his property.

These courts seem to read *Cunningham* as saying that if all claimants are fraud victims, then they are similarly situated. Further, when there are such "similarly situated" claimants, they do not allow tracing. Thus, they depart from the traditional rule that when Victim A can definitely trace or identify his property, and Victim B's property has been dissipated, they are awarded different remedies in restitution.²⁰⁸ Under restitution law and *Cunningham*, they are *not* similarly situated despite their common victimhood. Though A and B are both equally victims, they are not similarly situated in terms of their rights and what the court owes them. This is because equitable remedies are not reliant on a claimant's status as a victim.²⁰⁹ If it were otherwise, all tort victims would have priority over creditors, which is not the case. A claimant's ability to trace or identify, and in so doing establish ownership over the property in question, earns him that priority.²¹⁰

²⁰⁷ This follows logically if one accepts the first principle.

²⁰⁸ See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 59 (Tentative Draft No. 7, 2010) ("Presumptions [that permit tracing into or through a commingled fund in a contest between a restitution claimant and a wrongdoer] may not be used to create priorities between restitution claimants whose rights to assets in a commingled fund are otherwise indistinguishable."). For a decision treating A and B above equally, see *United States v. Bobbie Stacy Andrews*, No. CR-06-208-T, 2007 U.S. Dist. LEXIS 18914, at *16 (W.D. Okla. Mar. 15, 2007).

²⁰⁹ RESTATEMENT OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 215 cmt. a (1937) ("Where a person wrongfully disposes of the property of another, the other is not entitled to priority over the general creditors of the wrongdoer merely because of the character of the wrong done to him.").

²¹⁰ *Id.* § 215(1) ("[W]here a person wrongfully disposes of the property of another but the property cannot be traced into any product, the other has merely a personal claim against the wrongdoer and cannot enforce a constructive trust or lien upon any part of the wrongdoer's property.").

C. *An Accidental New Legal Doctrine? – “Forced Sharing” and Its Radical Implications*

Faced with these cases, one must consider whether they represent a new direction in restitution law. Hanoch Dagan, another of orthodox tracing’s staunch critics, seems to believe so. In his recent book, he states:

[A] specific rule is carved out in cases involving the so-called Ponzi scheme In these cases all the victims of the same fraud are treated as a class and share *pro rata* in all the assets that any one of them can identify as (or trace to) his or her property.²¹¹

This is indeed the rule in a number of cases in the *Durham* and *Forex* progeny.²¹² But its lack of support in either orthodox restitution principles or the Supreme Court’s decision in *Cunningham* should make one pause before accepting it wholesale.

Whether these cases are an aberration or the new direction of restitution, there is no denying that they enforce a new, and rather revolutionary, legal principle. This principle says: “If you are a victim, and there happen to be other victims of the same wrongdoer, you must share your property with the other victims to equalize the losses that all of you experienced.” Such a rule is an exceptional one in American law, with its long focus on the protection of individual property.²¹³ But the outcomes of these cases are fairly closely in line with tracing critics’ proposals. This may be either an intentional realization, or simply a fluke – the result of a withdrawal by restitution, its rules, and principles from the broader legal consciousness.

Despite the support a “forced sharing” principle would undoubtedly receive (or is receiving) from the heterodoxy, it is without foundation in orthodox restitution. Can such a legal principle be seen as an obvious product of *Cunningham*? Should cases applying “forced sharing” stand as valid precedent? The answer to each of those questions must be “no.” Three common elements of the extreme *pro rata* cases force the conclusion that judges applying the legal principle of “forced sharing” do so out of “equitable” intentions but not principles of equity, and that the application of such a large departure from restitution law has been accidental, rather than intentional.

First, one would expect such a dramatic change in the law to be accompanied by at least *some* disciplined analysis and reasoned rejection of traditional restitution principles, followed by the announcement of a new legal principle. Not only is any of that conspicuously absent,²¹⁴ but also the cases

²¹¹ DAGAN, *supra* note 51, at 302.

²¹² See *supra* Part III.B.

²¹³ See, e.g., JENNIFER NEDELSKY, PRIVATE PROPERTY AND THE LIMITS OF AMERICAN CONSTITUTIONALISM 225-26 (1994).

²¹⁴ RESTATEMENT (THIRD) RESTITUTION & UNJUST ENRICHMENT § 59, reporter’s notes to cmt. g (Tentative Draft No. 7, 2010) (“[T]he decisions cited do not purport to establish,

misapply basic restitution law and tracing rules. For example, they never reject direct tracing per se, they just read *Cunningham* as saying “tracing [is] suspended in Ponzi cases,” glossing over the distinction that exists, and which *Cunningham* clearly made, between direct and presumptive tracing. The forthcoming Restatement (Third) of Restitution and Unjust Enrichment takes the position that given the lack of coherent explanation for this “forced sharing” principle, it seems reasonable to conclude that it is the result of confusion or misapplication of restitution law rather than a conscientious new trend.²¹⁵

Second, although “pro rata” distribution may initially seem like an easy idea to swallow, the actual results of a “forced sharing” principle are foreign to traditional notions of property law. By enforcing pro rata distribution over property that has been specifically identified or traced, they are reducing the remedy that would otherwise be that claimant’s. This constitutes an imposition of liability on the effective owner of the property in question with respect to the other victims who are unable to trace.²¹⁶ The source of this liability is nothing more than the principle that where a wrongdoer harms successive victims, and some are harmed more than others, those that came out better should compensate those who came out worse to equalize their losses. This principle effectively forces “winners” to share their property with “losers.”

The cases do proffer their own normative determination that denying tracing seems more “fair” or “equitable.”²¹⁷ But what is fair about imposing a liability on a victim of a wrongdoer simply because that wrongdoer had other victims? Say Wrongdoer is a tortfeasor who negligently permits oil waste to spill out from his property and damage the property of his neighbors, *A*, *B*, and *C*. Each of these victims started out with property of identical nature and value. However, simply because of their location with respect to the wrongdoer’s property, or possibly because of the choices that the wrongdoer made with respect to his own property, *A* and *B* end up suffering \$200 in property damage, but *C* only suffers a \$50 loss. Under the forced sharing principle, the court should order *C* to pay *A* and *B* \$50 each to repair their property, thereby equalizing each of their losses at \$150. Or what if Wrongdoer is a tortfeasor who negligently crashes his automobile, injuring *A*, *B*, and *C*? *A* and *B* end up

delimit, or justify the principle necessary to explain the results, which appears inconsistent with fundamental rules of property.”).

²¹⁵ *Id.* (“Until the[] results [of the extreme pro rata cases] are forthrightly explained and adequately justified, it seems safe to regard them as the product of error and inattention.”).

²¹⁶ *Id.* (“The rule that is effectively being applied in cases like *Durham* imposes a liability for contribution between victims of a common fraud – though a liability imposed in the court’s ‘discretion’ – so that victims who by good fortune have not lost their assets are compelled, when the court sees fit, to make up the losses of those who have.”).

²¹⁷ *See, e.g., United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996) (“The lower court in this case chose not to impose a constructive trust in [the claimant’s] favor because it seemed inequitable to allow [the claimant who could trace] to benefit merely because [the wrongdoer] spent the other victims’ funds first.” (emphasis added)).

with \$50,000 in medical bills, whereas *C* only ends up with \$5000. Once again, the forced sharing principle would make *C* liable to *A* and *B*.

And what are the limits of such a principle? If “forced sharing” is justified, why limit it to victims who can trace? Why not impose liability on all victims who came out whole? Say Wrongdoer defrauds *A*, *B*, *C*, and *D*, in that order. After defrauding *A* and *B*, Wrongdoer dissipates their money. He then defrauds *C*, but invests *C*’s money in real estate so *C* can trace, thereby *C* loses nothing. He then defrauds *D*, but *D*’s check bounces so *D* loses nothing. If it is fair to make *C* share to reduce *A* and *B*’s losses, why would it not be fair to make *D* cough up something as well? After all, he is also a victim of Wrongdoer, and he is making out better than the other victims, based on nothing more than “the luck of the draw,” so to speak. And if *D* *should not* be made to share, what would explain the idea that *C* is “similarly situated” with *A* and *B*, but *D* is not?

Even though at first glance, forced sharing might seem fairer to the other victims of the wrongdoer, in reality it is a windfall to them and extremely *unfair* to the victims being forced to share. The claimants who cannot trace, like the tortfeasor’s less fortunate victims, have suffered losses as a result of the wrongdoer’s actions, and their remedy is against him in money damages. Instead, without any valid justification, courts are taking away property from the claimants who can trace, or identify, and thereby establish their ownership – the more fortunate victims – and transferring it to the other victims simply to “even things out.” As long as those victims have no responsibility for the wrongdoing, this can hardly be called an “equitable” result.²¹⁸

Finally, the forced sharing cases define “equitable discretion” in a very dangerous way,²¹⁹ directly stating that whether or not to apply tracing is simply “at the election” of the trial judge.²²⁰ The notion that “equitable” is the equivalent of “completely discretionary” is wrong.²²¹ Though there may be more room for discretion in equity than at law, restitution principles are not

²¹⁸ Cf. DAN B. DOBBS, *DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION* 27 (2d. ed. 1993) (“If the right is a right against *A*, then the remedy must not run against *B*. *B* may be unavoidably affected by what happens to *A*, but no remedy should run against *B* when *B* has violated no rights.”).

²¹⁹ Cf. EDWARD D. RE & JOSEPH D. RE, *REMEDIES: CASES & MATERIALS* 7 (6th ed. 2005) (“[T]he granting of equitable relief ‘in the discretion of the chancellor’ was always understood to mean a *judicial discretion* to be exercised by the application of established principles and precedents. To imply whim or caprice does violence to the wisdom and integrity of the chancellors who strove to give vitality to Justinian’s three main principle’s of justice: ‘[t]o live honestly, to hurt no one, and to give everyone his due.’”).

²²⁰ See, e.g., *United States v. Durham*, 86 F.3d 70, 73 (5th Cir. 1996) (citing *United States v. Vanguard Inv.*, 6 F.3d 222 (4th Cir. 1993); *SEC v. Elliott*, 953 F.2d 1560 (11th Cir. 1993)).

²²¹ RESTATEMENT (THIRD) *RESTITUTION & UNJUST ENRICHMENT* § 59, reporter’s notes (Tentative Draft No. 7, 2010) (“[E]quitable discretion has never meant that rules are either applied or ignored as the chancellor might elect.”).

solely at a judge's whim.²²² As Judge Posner discerningly states, "Modern equity has rules and standards, just like law."²²³ And a judge is not free to do whatever feels right while disregarding long established principles of restitution.²²⁴

The multiple fraud victim example in which Brian's recovery turned out to be greater than Amber's or Celeste's illustrates this.²²⁵ In that case, the court would not have to apply any normative judgment about who *should* get what. The way the parties made out was solely a product of their losses. Amber lost more than Brian because the money taken from her was consumed. By enforcing a sharing principle, a court ignores these differences in *what happened* to each claimant, and the fact that these differences affected the rights that they each had. And this is further proof that the "forced sharing" principle is an unconscious alteration of restitution law.

CONCLUSION

This Note seeks to bring attention to a line of cases which seem to establish a new principle of "forced sharing" in restitution. Such a principle is without foundation in restitution theory or in common law practice, and glosses over the clear distinctions made in *Cunningham v. Brown*. On the other hand, some already advocate for forced sharing as the "specific rule carved out" for Ponzi cases.²²⁶ These decisions lend support to critics of tracing, some of whom would have tracing disallowed altogether and would remove priority for restitution claimants. But unfamiliarity with restitution principles unfortunately abounds. And what likely is occurring is an unintentional redevelopment of restitution law. Those who object to tracing anyway will not

²²² *In re Grand Jury Proceedings*, 894 F.2d 881, 887 (7th Cir. 1990) (Posner, J.) ("We do not suggest that equitable discretion is unlimited. . . . [A]lthough the ratio of rules to standards is lower in equity than in law, in cases where the plaintiff has an established entitlement to an equitable remedy the judge cannot refuse the remedy because it offends his personal sense of justice."). For further sources, see the extensive historical discussion of this issue in *Seguros Banvenez, S.A. v. S/S Oliver Drescher*, 761 F.2d 855, 863 (2d Cir. 1985), which is cited by Judge Posner in *Grand Jury Proceedings*, 894 F.2d at 887.

²²³ *Grand Jury Proceedings*, 894 F.2d at 887.

²²⁴ *Id.* ("A modern federal equity judge does not have the limitless discretion of a medieval Lord Chancellor to grant or withhold a remedy."); *Okaw Drainage Dist. v. Nat'l Distillers & Chem. Corp.*, 882 F.2d 1241, 1245 (7th Cir. 1989) (Posner, J.). Compare this with the *Durham* approach:

In entering a restitution order, adherence to specific equitable principles, including rules concerning tracing analysis are "subject to the equitable discretion of the court." Sitting in equity, the district court is a "court of conscience." *Acting on that conscience*, the lower court . . . held that following the tracing principle would be inequitable.

Durham, 86 F.3d at 73 (citations omitted) (emphasis added).

²²⁵ See *supra* Part II.A.

²²⁶ Dagan, *supra* note 44, at 302.

oppose preventing a claimant from doing so. But claimants denied the right to claim identifiable property might seek a justification more solid than that offered in the cases so far. While the Ponzis and Madoffs²²⁷ of the world are on the rise, these types of situations will be brought before judges more frequently. The question is thus: Though a situation in which multiple people are victimized is never a happy one, why should owners be forced to share?

²²⁷ The Madoff situation, given the design and proportion of the scheme, is likely one in which pro rata distribution would be appropriate; it may be that no victim is able to successfully trace without the use of presumptions.