

TRACING PRINCIPLES IN REVISED ARTICLE 9 § 9-315(b)(2): A MATTER OF CARELESS DRAFTING, OR AN INVITATION TO CREATIVE LAWYERING?

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I. INTRODUCTION

As early as 1992, the Permanent Editorial Board for the Uniform Commercial Code (UCC) recommended changes to the text of Article 9. After years of work on this project, the revised version has finally been sent to the States and has been widely accepted, having become effective on July 2001.¹ The changes from the prior version of Article 9 are indeed numerous, and scholars have been busy bringing the breadth of these changes to light. However, this note focuses on one rather narrow, and somewhat ambiguous, point of change – a revision that has potentially widespread implications for the shape of secured transactions. This note covers revised Article 9's treatment of tracing principles and, more particularly, how the processes in these principles can be used to identify commingled proceeds in deposit accounts under revised Section 9-315. This new Section 9-315 is markedly different than its counterpart in the prior version's Section 9-306.² This note will attempt to highlight some of the benefits of the revision in terms of its practical use for lawyers and courts, as well as some of the problems that will likely be encountered in its application in real cases.

By way of explanation, it should be noted that “tracing” is the process used by courts in many different areas of law to identify and segregate property that has been mingled with other property in such a manner that it has lost its identity. This includes all types of property, from logs in a river or wheat in a silo to cash in a deposit account. For example, well-established tracing rules are used in community property jurisdictions when divorcees are faced with the task of segregating the marital and the community property. Divorce is merely one of a host of situations where courts need to use tracing to “identify” and

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¹ U.C.C. § 9-102 cmt. 2 (2000). See also Bruce A. Markell, *Symposium on Revised UCC Article 9, From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 969 (1999).

² Because this note undertakes a comparison of the current Article 9 with the revised version on the brink of the delayed effectiveness date, there is a potential for confusion in referring to Article 9 and using the terms “current” and “former;” hence, the pre-revised Article 9 is referred to as “former” Article 9, and the post-revision Article 9 is the “current” version, despite the fact that not all the jurisdictions have currently adopted the revised version.

segregate property in order to assign ownership to it. Tracing becomes especially important in the context of secured transactions when collateral is sold by a debtor, and the proceeds of the sale are placed into a deposit account containing other funds belonging to the debtor. When this occurs, the critical question for the secured creditor is, how may it go about reclaiming collateral that has “disappeared” through the debtor’s careless (or, in some cases, unscrupulous) acts?

A. *Tracing Principles In Common Secured Transactions*

In order to more fully understand the tracing concept, consider the following hypothetical. Assume Andrew wants to purchase a car from Bob for \$1,000 but cannot pay the whole sum all at once. The two agree that Andrew will pay \$200 installments over five months, from January through May, with payments due on the first day of each month. The parties execute a promissory note, security agreement, and financing statement (which is timely filed), describing the car as collateral, thereby giving Bob the right to repossess the car if Andrew defaults on the terms of the agreement. At that point, Bob may feel “secure” in the knowledge that, if the payments are not forthcoming, he is empowered to repossess the car in order to recoup anything due on the note. Now assume that, on March 15 (a little over three months later), with \$400 remaining due under the note with Bob, Andrew discovers that he can no longer afford to make the payments. Without getting permission from Bob, Andrew sells the car to Charles on March 16 for \$400 – exactly the amount that Andrew owes on the note. As long as Andrew uses the money to pay off the note, there will likely be no problem.

However, assume instead the worst case scenario: Andrew takes the \$400 in proceeds, places it into his bank account and, instead of paying off Bob, pays his rent. When Bob does not receive his money on April 1, he will demand return of the car (his collateral), which is now owned by Charles. Former Article 9 dealt with this situation under Section 9-306, which provided in pertinent part: “a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof [unless the sale was authorized by the secured party], and also continues in any *identifiable* proceeds (emphasis added).” Thus, Bob’s security interest continues in the car itself and he has the right to attempt to repossess. In the alternative, Bob could choose to pursue the proceeds (\$400) of the sale between Andrew and Charles.

While former Section 9-306 states the general rule – that Bob’s security interest continues in the identifiable proceeds of the sale of his collateral – revised Article 9 identifies some exceptions to this rule. For example, under the new Section 9-315(a)(1), a security interest in collateral terminates if the secured party “authorized disposition free of the security interest”³ Thus, had Bob authorized the sale of the car free of the security interest, he would not be entitled to pursue the car, but rather, only the identifiable proceeds (which were deposited into Andrew’s account). Other exceptions exist as well,⁴ which

³ Also explained at U.C.C. § 9-315 cmt. 2 (2000).

⁴ Likewise, this concept is explained at U.C.C. § 9-315 cmt. 2 (2000). Another exception, noted in U.C.C. § 9-315 cmt. 2 (2000), which will be explained more fully later in this note,

will be addressed subsequently throughout this note, but for now, it suffices to understand that limited circumstances do exist where collateral can be disposed of free of security interests.

1. Section 9-306 and Identifiability

The key restriction that Section 9-306 placed upon Bob was that the proceeds of the sale between Andrew and Charles be identifiable. As mentioned previously, tracing is the method in Article 9 by which these proceeds are identified and, in a sense, recaptured as collateral. This method is critical when proceeds are placed in bank deposit accounts because the debtor often has other funds entering and exiting its account on a regular basis. To continue with the prior hypothetical, assume that, after Andrew pays his rent (\$300), \$100 remains in the account. A week later, Andrew deposits his paycheck in the amount of \$500, bringing the balance up to \$600. Then Andrew withdraws \$500, which he spends on groceries and entertainment, bringing his balance down to \$100 at the end of March. Finally, Andrew receives one last paycheck on March 27. On that date, his bank ledger would look like this:

Date	Deposit	Withdrawal	Balance
March 15	None	None	\$0.00
March 16	\$400 (proceeds of car)		\$400
March 17		\$300 (rent)	\$100
March 25	\$500 (paycheck)		\$600
March 26		\$500 (food/etc)	\$100
March 27	\$500 (paycheck)		\$600

On April 1, Bob will not receive his \$200 car payment, which is an act of default under the terms of his security agreement with Andrew. At this point Bob will accelerate his loan and demand immediate payment of the remaining \$400. Since Andrew has many creditors calling, and is not able to pay them all, he declares bankruptcy on April 1, leaving all his creditors (Bob included) to fight over his assets. The most immediately appealing asset will be the cash in Bob's account – and, as mentioned, Section 9-306 entitles Bob to payment of the proceeds of the car sale to Charles. Thus, Bob will claim entitlement to part of the remaining \$600 balance as his collateral. This is an area where tracing principles become critical. As mentioned, Bob may still pursue repossession of the car itself, but that process may be time consuming and costly. If he can establish a claim to any of the money in the account, Bob may be able to shortcut that process in order to satisfy his claim. Through tracing, Bob can identify that part of the money in the bank account to which he is entitled.

is the rule found at U.C.C. § 2-403(2) (2000). This rule states that a secured party who entrusts collateral to a merchant who deals in goods of the kind gives that merchant the power to transfer the collateral, free of the security interest to buyers in the ordinary course of business. Another rule along these lines described in this note is U.C.C. § 9-331 (2000), which states that purchasers of negotiable instruments, negotiable documents, and securities take free of perfected security interests, even if the secured party does not authorize their disposition.

2. *Tracing under Revised Article 9: Section 9-315(b)(2)*

Under former Article 9, the question of which of the funds Bob is entitled to would be relatively simple. Various jurisdictions employ a few different methods of tracing secured collateral, including a few, widely used and rigid equitable principles, which will be discussed below. However, the revised version of Section 9-306, now found at Section 9-315, may well change the way in which commingled funds are traced. The new text reads, in pertinent part at 9-315(b):

Proceeds that are commingled with other property are identifiable proceeds . . . if the proceeds are not goods, to the extent that the secured party identifies the proceeds by a method of tracing, *including application of equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved* (emphasis added).

This italicized language, new to revised Article 9, is the focus of this comment. Under revised Article 9, commingled property may be identified through the use of equitable principles permitted under non-Article 9 law – but the new language does not identify what those principles, or other areas of law, might be. This comment attempts to uncover what meaning the Article 9 drafters intended to ascribe to this language.

3. *The Equitable Tracing Principles*

While the rule seems simple enough at face value, the fact is that very few equitable tracing principles are employed in areas of law other than secured transactions. What's more, some of these tracing principles are already employed by a few jurisdictions in some secured transactions contexts. These principles include the following, which will be discussed at length throughout the remainder of this note: (a) the *lowest intermediate balance rule* (LIBR), adopted from trust accounting, which is currently the mainstay of secured transactions tracing; (b) the *pro rata distribution hybrid of the lowest intermediate balance rule*, used in more complicated commingling cases, where multiple trust funds are mingled, a scenario that presents complex priority problems; (c) the *first-in first-out rule* (FIFO) and the similar *last-in first-out rule* (LIFO), also principles of trust accounting; (d) the *community-out first rule*, from community property law, which is actually the same as the *trustee-out first rule* and the functional equivalent of the lowest intermediate balance rule; and (e) the rule of "*approximate correctness*"⁵ from both trust and property law.

Perhaps the drafters included the new Section 9-315 language because they perceived inequities in the manner in which commingled funds are currently being traced and segregated: primarily through use of the lowest intermediate balance rule.

As this note will argue, reviewing these equitable tracing principles actually raises many more questions than it answers about how they are supposed to function in the Article 9 context. The lowest intermediate balance rule, as will be explained, is generally applied in a wooden manner by the courts, at times resulting in rigid consequences for innocent creditors. Assuming that the draft-

⁵ The author invented this name for reference in this note; the concept does not otherwise have an assigned reference or title in the courts that have adopted it.

ers wanted to change this area of law, it is difficult to understand why they have tackled the problem in the manner in which they have. In fact, after reviewing these equitable principles, it appears that the drafters may be guilty of sloppy drafting in that the immediate implications of this new rule do not appear to have been considered very thoroughly. Adopting tracing principles from other areas of law is instantly problematic in secured transactions because of the complex priority issues that have to be dealt with any time collateral is secured by more than one creditor. These problems can present themselves even in the most basic cases, not to mention complex commercial transactions. While the lowest intermediate balance rule may engender harsh results in some cases, courts have generally found the rule to be competent in dealing with priority issues. In addition, it should be noted that some of the equitable tracing principles discussed in this note, more specifically LIFO and FIFO, have already been rejected in some jurisdictions because they are perceived to be inferior to the lowest intermediate balance rule.

The purpose of this note is not to advocate the return to former Section 9-306 with its emphasis on the lowest intermediate balance rule. In fact, that rule will be analyzed and both its strengths and weaknesses will be considered in order to show that it does function better in some cases than in others. In addition, this note analyzes equitable tracing principles used in other areas of law and attempts to make sense of the options now available to practitioners and courts when dealing with secured transactions tracing issues in the course of litigation. The gift of alternatives is the fruit of this new change in the law.

It is noteworthy to mention that there are cases where the lowest intermediate balance rule is simply ineffective in achieving fair results; thus, practitioners can often point out the inadequacies of whatever tracing rule their courts generally apply, and argue that some other rule should be used in a particular case. While each of the principles discussed herein may have problems in particular cases for one reason or another, this is to be expected due to the complexity of secured transactions law. However, telling lawyers that they can only use the lowest intermediate balance rule for tracing is like telling a mechanic he can only use a screwdriver to fix your car. The real efficacy of this new language is that it may allow lawyers to decide which of the various tracing principles can best be employed to advocate for their client in a particular case. Courts have the ability to go beyond the traditional lowest intermediate balance rule (or whatever other rule is employed in a particular jurisdiction) and employ a method that will better achieve fair and equitable results to the parties before them. In other words, while any one of these tracing principles is highly imperfect in dealing with all commingling cases, the new language gives more tracing tools to lawyers and courts facing tracing issues. It invites courts to apply the various principles as equity may require, which may lead to more palatable results in many cases. This note analyzes these new options available to courts.

II. ARTICLE 9'S PRESENT APPROACH TO TRACING PRINCIPLES

A. *The Lowest Intermediate Balance Rule*

In order to understand why some parties might be interested in using this new Article 9 language to their benefit, one should begin by considering the manner in which tracing is currently dealt with under secured transactions law. Comment 3 to Section 9-315 indicates, not surprisingly, that “[a]mong the ‘equitable principles’ whose use other law may permit is the lowest intermediate balance rule.” This rule is used extensively in many American jurisdictions for the purpose of tracing commingled collateral.⁶ Adapted from the trust law,⁷ it permits a beneficiary of trust funds that have been wrongfully disposed of by the trustee to acquire a lien on property purchased with the trust funds in breach of the trust. A key element, however, is that the product of the trust property be identifiable (traceable).⁸ As a result, if the product is easily identifiable, it is captured as collateral for the benefit of the trust; however, if the product is not easily identifiable, then fictional identification principles (such as those described in this paper) are used to identify the trust property, to the benefit of the trust. *In re Oriental Rug Warehouse Club*⁹ is a typical example of this rule applied. In that case, Oriental (a rug dealer) entered into a “consignment agreement”¹⁰ with Yashar (a supplier), in which Oriental agreed to sell Yashar’s rugs and pay a total consignment price of \$106,073 for these.¹¹ In breach of this arrangement, Oriental sold some of the rugs, but invested the proceeds into new inventory from other suppliers instead of remitting them.¹² Since this action constituted a breach of the consignment agreement, Yashar repossessed its unsold rugs from Oriental.¹³ Oriental subsequently filed for Chapter 11 bankruptcy, with \$64,243 still remaining due to Yashar from Oriental.¹⁴ At that point, Yashar claimed that it was entitled to a lien on Oriental’s current

⁶ Jurisdictions employing this rule include Alabama, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, Nebraska, North Carolina, Oklahoma, Pennsylvania, Wisconsin, and Utah; see *General Motors Acceptance Corp. v. Norstar Bank*, 532 N.Y.S.2d 685, 687 (1988).

⁷ RESTATEMENT (SECOND) OF TRUSTS § 202 (1959), reviewed by U.C.C. § 9-315 cmt. 3 (2000), states:

(1) Where the trustee by the wrongful disposition of trust property acquires other property, the beneficiary is entitled at his option either to enforce a constructive trust of the property so acquired or to enforce an equitable lien upon it to secure his claim against the trustee for damages for breach of trust, as long as the product of the trust property is held by the trustee *and can be traced*.

(emphasis added).

⁸ *Id.*

⁹ 205 B.R. 407 (Bankr. D. Minn. 1997), cited in LYNN LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH (3d ed. 2000).

¹⁰ Revised Article 9, pursuant to U.C.C. § 9-109(a)(4) (2000), governs consignment agreements of the type created in this case; the court explains that this agreement would be treated like a standard floorplan arrangement.

¹¹ *Oriental Rug*, 205 B.R. at 409.

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

inventory, in the amount of the remaining debt.¹⁵ The bankruptcy court was unwilling to grant this relief based on then-current Article 9 tracing law.¹⁶

The court indicated that the secured party has the burden to establish that its proceeds are identifiable: “the secured party must ‘trace’ the claimed proceeds back to the original collateral.”¹⁷ In other words, Yashar had the burden to establish a tie between the proceeds of his rugs and the purchase of the new inventory. Elaborating on the difficulty with which creditors like Yashar must establish their claims, the court noted:

Special tracing problems arise when cash proceeds are commingled with other deposits in a single bank account. Because of the fungible nature of cash proceeds, there is some authority that cash proceeds are no longer identifiable once they are commingled with other funds. The majority of courts, however, have established equitable principles borrowed from the law of trusts to identify whether commingled funds constitute proceeds received from an earlier disposition of collateral. In particular, these courts have used the “intermediate balance rule,” which creates a presumption that the proceeds of the disposition of collateral remain in a commingled account as long as the account balance is equal to or exceeds the amount of the proceeds. Therefore, the intermediate balance rule presumes that a debtor who spends money from a commingled account spends first from his own funds.¹⁸

This court’s statement touches on two key facets of the lowest intermediate balance rule: (1) the difference between actual and fictional tracing; and (2) the manner in which the lowest intermediate balance rule works.

1. Actual v. Fictional Tracing

The *Oriental Rug* court explains the fact that “identifiability” in the cases where tracing is required is actually a term of art; as the court explains, money is fungible and, therefore, it may be impossible to tell exactly what money belongs to different creditors in a commingled account.¹⁹ For example, by referring again to Andrew’s ledger, it is impossible to tell, with all the debits and credits since the deposit of the proceeds, which of the funds may still be considered “proceeds” of the car’s sale:

Date	Deposit	Withdrawal	Balance
March 15	None	None	\$0.00
March 16	\$400 (proceeds of car)		\$400
March 17		\$300 (rent)	\$100
March 25	\$500 (paycheck)		\$600
March 26		\$500 (food/etc)	\$100
March 27	\$500 (paycheck)		\$600

Consider that, once these proceeds were deposited, \$300 was spent on rent, and a new credit of \$500 was added to the account. At this point, the question is presented: did the new deposit of funds on March 25 replenish Bob’s collateral, or was at least part of that money irretrievably lost when

¹⁵ *Id.*

¹⁶ *Id.* at 414.

¹⁷ *Id.* at 411.

¹⁸ *Id.* (citations omitted).

¹⁹ *Id.*

Andrew paid his rent? Since it is impossible to answer this question in the “actual” sense of identifying exactly which dollars remain, equity substitutes a fictional answer in these cases, such that courts are able to deal with these complicated questions. As a result, the goal of “tracing” is not to trace anything at all in many cases, but rather serves as an equitable substitute for the impossibility of specific identification.

In some cases, courts employ fictional tracing principles for purposes other than to resolve creditor disputes. For example, in *Hanigan v. Trumble*, a fraudulent transfer case, money that was taken wrongfully was contributed to the construction of a house.²⁰ Citing to several state appellate decisions,²¹ the *Hanigan* court stated that, when money is wrongfully taken and then “converted into another type of asset” (here, it was converted to real property), tracing is necessary to identify how much of the value is attributable to the contribution of such money.²² As the state district court had awarded the innocent party the entire house (obviously without employing tracing), the state Supreme Court reversed and ordered that the victim was entitled to a constructive trust²³ on the property for the amount determined (via tracing) to have been obtained through fraud.²⁴ Here, the court did not apply any fictional tracing principle, but actually required proof of the amount of property that had been wrongfully taken be traced into the commingled mass. While the opinion does not state exactly what method should be employed to trace the wrongfully taken funds, it would appear that such a determination requires a ‘battle of experts.’ In some cases, these battles are appropriate – as here, where it is actually possible to show proof of a certain amount of funds entering an account. But where that is simply not possible because of extensive commingling – and where the courts have to pronounce some adjudication of the rights of the parties – then courts must engage in fictional tracing.

To more fully understand when actual tracing (as opposed to fictional tracing) is employed by the courts, compare *Trumble* with the following case. In *Farmers and Merchants National Bank v. Sooner Cooperative*,²⁵ the Oklahoma Supreme Court explained the dual nature of tracing concepts. In that case, a farmer whose crops were used as collateral for a loan participated in a federal

²⁰ 562 N.W.2d 526 (Neb. 1997).

²¹ The court cited cases from various jurisdictions, including: *Arduin v. McGeorge*, 595 So.2d 203 (Fla. Dist. Ct. App. 1992); *Estate of Russell*, 932 S.W.2d 822 (Mo. App. 1996); *Crestar Bank v. Williams*, 462 S.E.2d 333 (Va. 1995); *McFarland v. McFarland*, 470 N.W.2d 849 (S.D. 1991); *Cox v. Waudby*, 433 N.W.2d 716 (Iowa 1988); *Philadelphia v. Mancini*, 246 A.2d 320 (Pa. 1968).

²² *Hanigan*, 562 N.W.2d at 532.

²³ This court explained the purpose of constructive trusts, stating “[a] constructive trust is imposed when one has acquired legal title to property under such circumstances that he or she may not in good conscience retain the beneficial interest in the property.” *Id.* at 531. The court went on to explain that, while the legal title-holder is not deprived of title, the title-holder is nevertheless treated as though it had because it becomes a trustee “holding title for the benefit of those entitled to ownership thereof.” *Id.* (citing *Brtek v. Cihal*, 515 N.W.2d 628 (Neb. 1994)). By their very nature, then, cases where constructive trusts are imposed require tracing in order to identify the property upon which the constructive trust is to be imposed.

²⁴ *Hanigan*, 562 N.W.2d at 532.

²⁵ 766 P.2d 325, 325-26 (Okla. 1988).

payment-in-kind (PIK) program, wherein he received payment for crops that were never harvested.²⁶ When the farmer transferred the PIK payments to third parties, the secured bank sued for recovery. Under these facts, the court had to deal with the tracing issue the case presented once it determined that the PIK payments were de facto proceeds of the crops (and, thus, collateral).²⁷ In explaining its approach, the court said:

The goal of “tracing” is to establish what portion of a commingled account constituted proceeds of the collateral. In factually traceable situations, where proceeds can actually be traced into and out of an account, no resort to artificial tracing methods is needed.²⁸

The court then proceeded to explain that common artificial tracing methods include the lowest intermediate balance rule, as well as the “first in first out” (which is explained in the next section of this note) method of tracing.²⁹ However, as the court clarified, these methods should only be implemented when “proceeds have completely lost their identity.”³⁰ Because the court believed that the proceeds in the present case were *actually* traceable, it refused to use an artificial tracing method.³¹ This court’s holding illustrates that it is critical to determine whether an artificial tracing method or “actual” tracing is required in examining tracing principles from other areas of law.

2. *How the Lowest Intermediate Balance Rule Works*

The second key pointed out by the *Oriental Rug* court is the manner in which the lowest intermediate balance rule functions.³² Essentially, the rule assumes that the debtor spends his own money from the commingled account before he spends the creditor’s proceeds.³³ Thus, the creditor’s proceeds only remain in the account to the extent that the account balance remains at or above the amount of the proceeds.³⁴ As the debtor’s balance drops below the total amount of proceeds, the creditor’s collateral drops accordingly.³⁵ As Professor Palmer points out, even though the balance may later rise back up above the amount of the proceeds, “courts do not treat the later deposits as a restitution of

²⁶ The court described the Payment in Kind (PIK) program in the following manner:

The PIK program was instituted to alleviate the oversupply of grain which had accumulated on the market. Operated by the Commodity Credit Corporation, a branch of the USDA, the program gave participating farmers a quantity of grain in return for crops that otherwise would have been produced Payment from the CCC was often in the form of grain stored on the farmer’s land from an earlier harvest. In a series of paper transactions designed to avoid actually moving the grain, the CCC would purchase the farmer’s stored grain and credit it as payment in kind for the 1993 PIK program. The grain was then sold and the farmer received a check.

Id. at 326.

²⁷ *Id.* at 328.

²⁸ *Id.* at 329.

²⁹ *Id.* n.19.

³⁰ *Id.*

³¹ *Id.*

³² *In re Oriental Rug Warehouse Club, Inc.*, 205 B.R. 407, 411 (Bankr. D. Minn. 1997), cited in LYNN LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH (3d ed. 2000).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

the claimant's funds, and as a result, the claim against the account is limited to the lowest intermediate balance between the time of the commingling and the time when the rights of the claimant become fixed."³⁶ Applying this principle to Andrew's ledger (on pages 4 and 11) requires that Bob find the lowest balance in the account between the time the proceeds went in to the account, and the time Bob makes his claim on the account (at Andrew's bankruptcy). In our hypothetical, this tracing approach leaves Bob with only \$100 of his security intact.

In *Oriental Rug*, Yashar attempted to circumscribe this principle, arguing in effect that he should be able to obtain a lien on inventory purchased with Oriental's funds, without first establishing that the funds used to purchase such inventory came from Yashar's inventory.³⁷ Secured creditors like Yashar may decry the idea that they have the burden to carefully monitor their debtor's business practices to make sure they are not commingling their proceeds; However, as the *Oriental Rug* court illustrated, "both the case law and the leading commentaries are clear in this regard."³⁸

Since the lowest intermediate balance rule is so widely used (as the previous discussion demonstrates), and given that this rule is explicitly sanctioned in Comment 3 to Section 9-315, it will presumably continue to play an important role in Article 9 tracing.³⁹ Creditors in cases like *Oriental Rug*, whose collateral is misappropriated by unscrupulous debtors, can easily find fault with such a rule. The new language of 9-315, Comment 3 gives creditors like Yashar the ability to argue for a better alternative to the lowest intermediate balance rule.

B. The Hybrid: Lowest Intermediate Balance Combined with Pro Rata Distribution

The lowest intermediate balance rule has also been adapted to fit other similar, slightly more complicated cases as well. In *Oriental Rug*, for example, Yashar was the only creditor who sought to trace Oriental's rug sale proceeds. Indeed, cases of inventory financing clearly form the basis for some much more interesting problems, especially in cases with multiple creditors. In one such case, the Maine Supreme Court dealt with tracing issues by doing precisely what revised 9-315(b)(2) recommends that courts do when it borrowed principles from other non-Uniform Commercial Code law (here, trust law). In *Bombardier Capital, Inc. v. Key Bank of Maine*,⁴⁰ two creditors (both inventory lenders) sought tracing of commingled collateral. At issue was a mobile home dealer who had entered into separate floor plan financing agreements with both Bombardier and Key Bank, each of which was aware of the other's agreement

³⁶ GEORGE E. PALMER, 1 THE LAW OF RESTITUTION § 2.16 at 200 (1978).

³⁷ *Oriental Rug*, 205 B.R. at 413.

³⁸ *Id.*

³⁹ Another example of the popularity of the lowest intermediate balance rule, as pointed out by Professor Markell, *supra*, note 1, is the fact that it has been codified in California as the method to be used when tracing exempt funds. See CAL. CIV. PROC. CODE § 703.080(c) (West 1987). Interestingly, the statute is similar to revised Article 9 in that it recommends the lowest intermediate balance rule, unless "the exemption claimant or the judgment creditor shows that some other method of tracing would better serve the interests of justice and equity under the circumstances of the case." *Id.*

⁴⁰ 639 A.2d 1065 (Me. 1994).

with the dealer.⁴¹ In October 1991, the dealer sold two of the mobile homes financed by Bombardier and deposited the proceeds into its Key Bank account.⁴² After depositing these funds, the dealer drafted checks totaling \$59,843.53, to pay Bombardier on its loan.⁴³ Before the checks were presented, the account balance dropped to \$21,793.84 (clearly, some of the collateral had been spent).⁴⁴ However, when the checks were delivered to Bombardier a month later, there was plenty of money in the account to pay out the checks.⁴⁵ When Bombardier presented the checks for payment, they were thus provisionally credited the \$59,843.53.⁴⁶ Unfortunately, while the Bombardier checks were in the process of clearing, Key Bank noticed that some of its units had been sold by the dealer out of trust and it demanded payment for them immediately.⁴⁷ When the bank did not receive payment by the demanded deadline, it automatically debited the amount it was owed by the dealer, and applied the entire account balance to its own debt.⁴⁸

The court below awarded Bombardier \$45,078.34, based on its calculation of the lowest intermediate balance rule (which apparently consisted of the \$21,793.84 plus \$23,280.00 from sales of later Bombardier inventory).⁴⁹ Key Bank acknowledged that it had converted Bombardier's collateral, but argued that Bombardier should not be entitled to the full lowest intermediate balance, since Key Bank also held an interest in the proceeds deposited in the account, where the dealer was out of trust on its inventory loan.⁵⁰ Thus, the bank, borrowing from trust law, argued that the court should apply the lowest intermediate balance *pro rata*, which would give a proportional distribution of the proceeds in the account to each of the creditors.⁵¹ Under this argument, the court would give each of the creditors a proration of the \$45,073.84 remaining in the account, since the dealer was out of trust in the amount of \$88,906.17 and the dealer owed Bombardier \$59,843.53.⁵² Faced with this argument under the pre-revised Article 9, the Court noted that the code gave no specific guidance as to how to trace commingled funds in an account, and complained that "turning to the Code for guidance on this issue is like seeking the advice of the Sphinx."⁵³

⁴¹ *Id.* at 1065-66.

⁴² *Id.* at 1066.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Bombardier Capital*, 639 A.2d at 1066.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.* at 1066-67. Although the code was of no help to the court, the *pro rata* distribution method is a recognized tool courts have used to segregate commingled trust funds. See J.F. Ghent, Annotation, *Distribution of Funds Where Funds of More Than One Trust Have Been Commingled By Trustee and Balance is Insufficient to Satisfy all Trust Claims*, 17 A.L.R. 3d 937 (1968). Ghent classifies this method of commingled trust fund distribution as one of three recognized by the courts (the other two are discussed in this note as well). *Id.* at 939. The first method, he states, "is to relegate the trust beneficiaries to the status of general

For its part, Bombardier noted the discrepancy with borrowing the pro rata distribution method from trust law, arguing that such an approach assumes both parties (Bombardier and the bank) are innocent; however, in light of Key Bank's admitted conversion of its proceeds, Bombardier argued that such could not be the case.⁵⁴ The court agreed that a discrepancy does manifest itself when law, designed for one purpose, is exported to another, stating, "Bombardier's argument points up the difficulties involved in borrowing concepts from trust law to solve legal conflicts between secured parties."⁵⁵ Considering this difficulty, and considering the holdings of four other courts on similar issues, the court concluded, "[w]e determine that the law borrows a concept from equity without adopting the entire panoply of equitable principles."⁵⁶ As a result, the court found that had it applied the pro rata rule as it applies in trust law, and therefore could not reach an equitable determination of the case: "Conversion entitles a party to damages equaling the value of its property at the time of the conversion"⁵⁷ and the court believed that "to award Bombardier anything more than its pro rata share would result in a windfall."⁵⁸ In the end, the court did import pro rata distribution from trust law, but was unable to fully implement all of the equitable principles that would accompany that principle in the secured transactions context.

This case highlights the difficulty in the application of revised 9-315(b)(2). While the drafters clearly authorized courts to reach beyond the lowest intermediate balance rule, as the court did in *Bombardier Capital*, the drafters gave no real direction as to how this is to be done. Thus, while courts have difficulty determining how to trace under current Article 9, this new language may well add confusion to an already perplexing situation. At the very least, the *Bombardier Capital* case illustrates exactly the kind of power that this new 9-315 language gives to practitioners. While courts were previously tied to whatever tracing equity is accepted in their jurisdiction, the new 9-315(b)(2) language allows courts to follow the Maine Supreme Court's lead to creatively expand their current notions of tracing principles to fit broader situations, and to arguably achieve more just results. In other words, the revision may allow for real innovation in bringing new ideas to bear in resolving these more complicated cases.

C. *Deposit Accounts as Collateral and Revised Section 9-104*

Since the remainder of this note will be dedicated to describing other tracing principles that are currently in use in other areas of law, it is important to

creditors." *Id.* The second method he identifies is use of FIFO. *Id.* Finally, he states, "[t]he third method, recognized by most authorities as a just solution to the problem, is to distribute the remaining balance among the trust beneficiaries according to their pro rata shares." *Id.*

⁵⁴ *Bombardier Capital*, 639 A.2d at 1068.

⁵⁵ *Id.*

⁵⁶ *Id.* The court additionally referred to *Brown & Williamson Tobacco Corp. v. First Nat'l Bank of Blue Island*, 504 F.2d 998, 1000 (7th Cir. 1974); *In re Intermountain Porta Storage, Inc.*, 74 B.R. 1011, 1016 (Bankr. D. Colo. 1987); *Ex parte Alabama Mobile Homes, Inc.*, 468 So.2d 156, 161 (Ala. 1985); and *C.O. Funk & Sons, Inc. v. Sullivan Equip., Inc.*, 431 N.E.2d 370, 373 (Ill. 1982).

⁵⁷ *Bombardier Capital*, 639 A.2d at 1068.

⁵⁸ *Id.*

note one of the other wrinkles that revised Article 9 adds to adopting these “foreign” principles into secured transactions. Since Section 9-315 deals with tracing funds in deposit accounts,⁵⁹ it should be noted as a preliminary matter that the use of these very accounts as collateral for loans is now sanctioned by revised Article 9, whereas it formerly was not. Section 9-104, also a new addition to Article 9, does more than allow deposit accounts to act as collateral: it also simplifies the manner in which a bank may attach and perfect its interest in deposit accounts.⁶⁰ This section specifically permits “control” of deposit accounts by creditors, and states that:

A secured party has control of a deposit account if: (1) the secured party is the bank with which the deposit account is maintained; (2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account, without further consent by the debtor; or (3) the secured party becomes the bank’s customer with respect to the deposit account.⁶¹

As Comment 2 to Section 9-104 explains, control “may substitute for an authenticated security agreement as an element of attachment,” and if the “deposit account is taken as original collateral, the only method of perfection is obtaining control under this section.” If the *Bombardier Capital* case were decided under revised Article 9, another wrinkle would have been added to the problem of competing creditors with the addition of this new Section 9-104. Because Key Bank was lending to the dealer under a floor plan arrangement, there would have been a priority dispute that would be impossible to win at all by Bombardier (since the fund was in the control of Key Bank as the “bank with which the deposit account is maintained”⁶²) when the proceeds from the sale of the Bombardier-financed mobile homes were deposited into the account. Under the new Section 9-104 scheme, Key Bank would get the benefit of “controlling” the dealer’s deposit account, even though it has no authenticated security agreement with the dealer. As a result, this new control issue is an additional concern for lawyers who seek to incorporate non-Article 9 tracing principles into secured transactions.

D. *FIFO and LIFO*

Since the purpose of this inquiry is to look to other areas of law to determine whether their tracing principles work with secured transactions, the next principles to be examined are those that courts have already accepted for use with secured transactions. As mentioned above, the lowest intermediate balance rule is not really a tracing principle, but rather it is a convenient equitable device for fictional tracing in situations where real tracing is impossible.⁶³ Another such device is the “first in, first out” (FIFO) method of trust account-

⁵⁹ “Deposit account” is defined in U.C.C. § 9-102(29) (2000) as “a demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument.”

⁶⁰ U.C.C. § 9-104 (2000).

⁶¹ *Id.*

⁶² U.C.C. § 9-104(a)(1) (2000).

⁶³ See *supra* notes 19-31 and accompanying text.

ing. Professor Richard L. Barnes⁶⁴ describes the genesis of this principle in the 1809 English case, *Devaynes v. Noble*.⁶⁵ There, a partner in a five-man banking firm died, leaving £1717 on deposit.⁶⁶ The remaining partners continued to use the account for deposits and withdrawals until they later declared insolvency.⁶⁷ One of the bank's customers (Clayton) then sued the deceased partner's estate, since it was not insolvent.⁶⁸ As Professor Barnes explains:

The court announced the first in, first out presumption as the method for fixing the deceased partner's liability. That is, the withdrawals made after the death were used to first reduce the oldest deposits on hand. Since there had been £1717 in withdrawals since the death, the deposits on hand had been withdrawn and the deceased partner's debt had been discharged.⁶⁹

In a more modern decision regarding fraudulent transfer, *Commonwealth Land Title Insurance Co. v. John Doe*,⁷⁰ the Pennsylvania Supreme Court describes this method in greater detail:⁷¹

In attempting to trace funds, the Pennsylvania rule is "first in, first out." Pursuant to this rule, "the legal presumption is that moneys were paid out in the order in which they were paid in, and [the parties claiming ownership] are equitably entitled to any allowable preference in the inverse order of the times of their respective payments into the fund."⁷²

In order to flush out this principle, consider again the hypothetical Andrew's ledger:

Date	Deposit	Withdrawal	Balance
March 15	None	None	\$0.00
March 16	\$400 (proceeds of car)		\$400
March 17		\$300 (rent)	\$100
March 25	\$500 (paycheck)		\$600
March 26		\$500 (food/etc)	\$100
March 27	\$500 (paycheck)		\$600

If Bob attempts to trace his \$400 (proceeds of the car sale) into this commingled account, the March 16 deposit of Bob's proceeds will be the starting point of our analysis since, on March 15, there was no money on deposit. When the \$300 was paid out on March 17, Bob's proceeds were reduced accordingly. Next, when the March 25 deposit of \$500 is added, Bob's collateral amount does not rise back up. Since only \$100 of Bob's proceeds is still on deposit, that \$100 is used up entirely (as well as \$400 from the March 25

⁶⁴ Richard L. Barnes, *Tracing Commingled Proceeds: The Metamorphosis of Equity Principles Into U.C.C. Doctrine*, 51 U. PITT. L. REV. 281 (1990).

⁶⁵ 35 Eng. Rep. 781 (1809).

⁶⁶ *Id.* at 781-82.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ See Barnes, *supra* note 64, at 292.

⁷⁰ 577 A.2d 1358 (Pa. 1990).

⁷¹ Both the *Hanigan* and *Commonwealth Land Title* cases are fraudulent transfers cases. This is a perfect example of the fact that, while some courts deal with the need to assign ownership to property in different ways, both use tracing techniques though doing so in a different manner.

⁷² *Commonwealth Land Title*, 577 A.2d at 1360-61 (citation omitted).

paycheck) when the \$500 withdrawal occurs on March 26. The deposits are simply removed in the order of their deposits. Professor Barnes criticizes the logic behind this kind of principle as having “all the force of reason of a coin flip, but it benefits from the appearance of being less arbitrary. The appearance of evenhandedness is provided by the calendar of deposits and withdrawals.”⁷³

Courts also use a very similar principle called “last in first out” (LIFO) in tracing commingled funds.⁷⁴ This concept may suffer from the same critique as FIFO, but then so would the lowest intermediate balance rule. It applies the same logic as FIFO to similar facts, but simply does so in the inverse order.⁷⁵ In order to conceptualize this principle, consider a new balance sheet with a starting balance of \$500:

Date	Deposit	Withdrawal	Balance
May 14	None	None	\$500
May 15		\$400	\$100
May 16		\$100	\$0.00
May 17	\$300		\$300
May 25	\$500		\$800
May 26		\$500	\$300
May 27		\$100	\$200

In this case, the “last (money) in” is the \$500 deposit made on May 25. Applying LIFO then, that \$500 will be the first money out when subsequent withdrawals are made. Thus, when the \$500 withdrawal is made on May 26, the May 25 deposit has now been completely depleted under the LIFO fiction. Next, when the subsequent withdrawal is made on May 27 (\$100), that amount is then debited from the \$300 deposited on May 17, now that the May 25 deposit is gone. Thus, any subsequent withdrawals will be debited from this \$300, leaving only \$200 of the May 17 deposit still in the account.

As is readily apparent in the basic outline of these principles, no one of them has an inherent quality that makes it superior to any other in all circumstances. However, one may be far superior to the others, depending upon the circumstances. Using this new balance sheet, for example, suppose that the \$300 deposit of May 17th is the proceeds of a client’s collateral that was commingled into this account. The attorney would not want to argue that FIFO should be employed because his client’s collateral would have all been spent on

⁷³ See Barnes, *supra* note 64, at 294.

⁷⁴ *United States v. Intercontinental Indus., Inc.*, 635 F.2d 1215, 1220 (6th Cir. 1980) (“INI offers no reason why the district court should not have accepted the government’s use of LIFO in tracing the funds. LIFO is an accepted accounting method and its use was appropriate here.”). The court additionally notes that “[LIFO] is explained in great detail in the district court’s opinion.” *Id.* (citing *Taubman v. United States*, 499 F. Supp. 1133 (D. Mich. 1978)). See also *Chase Manhattan Bank, N.A. v. Traditional Investments Corp.*, 1995 WL 72410, at *3 (S.D.N.Y. Feb. 21, 1995) (accepting that distributions had to be made “under New York’s Clayton Rule” and explaining that this concept is also known as “LIFO”).

⁷⁵ *Chase Manhattan Bank*, 1995 WL 72410, at *3. This case explains (in the context of a commingled trust fund) that, under LIFO, “depositors receive their money ‘in the inverse order of the times of their respective payments into the fund.’” *Id.* (citing *In re A. Bolognesi & Co.*, 254 F. 770, 773 (2d Cir. 1918)). As it continues, “. . . in other words, under the Clayton Rule [LIFO] . . . trust monies [are] distributed before free or non-trust monies.” *Id.*

May 26. Using LIFO, as just explained, would preserve some collateral (\$200) for the creditor. Likewise, using LIBR, \$200 will be preserved for the creditor as well. Under revised 9-315(b)(2) all three principles (and the others still to be discussed) should be considered when a lawyer traces commingled collateral. Depending upon the facts of any particular case, a completely different outcome may result depending upon the fiction employed. Of course, this analysis is only the beginning because of the multitude of different priority issues that may be encountered in any one case. At the least, it appears that revised Article 9 allows some room for lawyers in jurisdictions that have clung to any one of these tracing fictions to bring in alternative arguments, as equity may demand in each case.

III. SURVEY OF TRACING LAW

As mentioned previously, since the drafters deliberately chose this new language for revised Article 9, there must be tracing principles (adopted in other areas of law) that can be adopted into secured transactions law. This section will proceed to review various areas of law and discuss if and how tracing principles are employed therein. While this survey does not attempt to recognize every potential situation where commingled funds might give rise to a tracing issue, it does attempt to recognize many of the more common situations where these principles might present themselves. In addition, the section attempts to explain some of the "typical" cases that illustrate these principles and make them accessible to practitioners as a starting point for further research, as well as serving to spark creativity in their application. As will be seen, courts rarely adopt specific tracing principles in other areas of law. Nonetheless, additional tracing principles do exist, as illustrated in the following cases.

On a more superficial note, this section attempts to separate the various cases herein presented into their distinct areas of law. This is the theoretic ideal for organizational purposes, but is difficult in practice since, as the reader will notice, there is substantial overlap between the situations presented. For example, one of the cases described involves both tax and trust law, and addresses both within the context of a bankruptcy. As a result, the cases are placed in the sections that most closely correspond with the area of law out of which the tracing principle arises.

A. *Divorce Law and Community Property*

A note on tracing must include a substantial overview of the various manners in which courts determine divorce property disputes. In the course of the author's research, it appeared clear that the two areas in which the most tracing issues arise are divorce and bankruptcy. The reason that tracing issues so typically arise when dealing with divorce law is that, when the divorcees separate, disputes over which of the property is separate and which is community can be nearly impossible. This quandary arises because married couples often commingle their funds during the marriage and seek to prove their "separate" share only when the marriage falls apart. Due to the difficulty of tracing funds in these cases, courts in community property jurisdictions begin the process with a

presumption that such funds are community property.⁷⁶ As the Texas Supreme Court in *McKinley v. McKinley* described the process:⁷⁷

It is the general rule that to discharge the burden imposed by the [community property] statute a spouse . . . must trace and clearly identify property claimed as separate property.⁷⁸ It is further well settled that when the evidence shows that separate and community property have been so commingled as to defy resegregation and identification, the burden is not discharged and the statutory presumption prevails.⁷⁹

Clearly, then, the funds that cannot be divided are treated as community property and will be split fifty-fifty in the divorce settlement in many cases.⁸⁰ As the court in *McKinley* makes clear, the parties have a right to show some proof that they can identify which of the funds are separate property.⁸¹ In some situations, the only way to make such a showing is presumably through the use of accounting records to show actual proof of deposits and withdrawals. For example, when dealing with the assets of a sole proprietorship in the divorce, one group of commentators explained that “[t]racing may be accomplished by examining books kept during the marriage which identify and keep separate the profits, (community) and the capital (separate). Careful record keeping which reveals that no commingling of properties or funds occurred enables parties to identify separate property.”⁸² In these cases, the expectation is clearly not that parties will engage in a fictional tracing exercise, but that they will bring in accounting experts to prove actual credits and debits to the account in order to carry the burden of proof as to the state of their property.

In *McKinley*, the parties sought to carry the tracing burden merely by introducing an account sheet.⁸³ However, the court found that this was not enough to identify the nature of the debits and credits to the account and subsequently decided that the parties had not satisfied their burden of proof.⁸⁴ It is worth noting that such an approach is possible only insofar as the funds are not commingled beyond recognition. In the event that the property’s ownership is beyond separation, a court following the *McKinley* rule should simply declare a “tie” and send each party home with an equal share of the assets.⁸⁵

What the principle illustrated in *McKinley* effectively accomplishes is the removal of a tracing burden altogether. This strict use of “actual” tracing appears to be used only in cases where it is impossible to tell how much of the contribution of separate property has been made into the commingled funds.

⁷⁶ *McKinley v. McKinley*, 496 S.W.2d 540, 543 (Tex. 1973).

⁷⁷ See also *Bahr v. Kohr*, 980 S.W.2d 723, 728 (Tex. Ct. App. 1998), which cites *McKinley* for this concept.

⁷⁸ The court cites *Tarver v. Tarver*, 394 S.W.2d 780 (Tex. 1965); *Wilson v. Wilson*, 201 S.W. 2d 226 (Tex. 1947); and *Chapman v. Allen*, 15 Tex. 278, 283 (Tex. 1885).

⁷⁹ *McKinley*, 496 S.W.2d at 543 (citations omitted).

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² Oliver S. Heard Jr. et al., *Characterization of Marital Property*, 39 BAYLOR L. REV. 909, 926-27 (1987).

⁸³ *McKinley*, 496 S.W.2d at 543-544, cited in *Bahr*, 980 S.W.2d at 729.

⁸⁴ *Id.*

⁸⁵ *Id.* at 543.

Such a result makes sense in divorce law, where there is a statutory presumption of equality with regard to the marital assets of the parties.⁸⁶

This is not to say that community property law is totally without fiction; in fact, beyond trust law, the author's research indicates that it is probably the area with the most creative methods for dividing commingled funds. California, for example, has well-developed case law discussing the ability of spouses to trace marital property throughout the marriage in order to determine whether it should be characterized as separate or community property.⁸⁷ Additionally, Texas has adopted a principle for tracing "separate" funds that have been commingled in deposit accounts and trust funds.

The Texas tracing principle (which cannot be used when the amount of the separate funds is unknown) is the "community-out-first" rule. One such case, *Sibley v. Sibley*, involved a scenario where different funds were mixed together into a deposit account containing both community funds and some of the wife's separate funds.⁸⁸ The amount of the wife's separate contribution was known to be \$3,566.38.⁸⁹ As a result the court held:

Equity impresses a resulting trust on such funds in favor of the wife and where the trustee draws checks on a fund in which the trust funds are mingled with those of the trustee, the trustee is presumed to have checked out his own money first, and is therefore an exception to the general rule.⁹⁰

The court then explained that it recognized a presumption that community funds were withdrawn from the account first, and so long as the account balance does not drop below the total amount of the separate property, then the separate property retains its separate character.⁹¹

Applying this principle to Andrew's ledger, so long as Bob knew the amount of the car's proceeds (\$400) that had gone into the account, and so long as the account balance never dropped below that amount (which is not the case here), then he could recover that amount. The rule is actually very simple, and some have argued that the rule should be called the "trustee-out first rule,"⁹² since the presumption is that the beneficiary's funds are spent only after the

⁸⁶ *Id.*

⁸⁷ See *infra* notes 96-110 and accompanying text.

⁸⁸ 286 S.W.2d 657 (Tex. Ct. App. 1955). *Sibley* is cited to by Heard et al., *supra* note 82, as the case in which this rule was first announced. Other Texas cases that have used this community-out first presumption include *Barrington v. Barrington*, 290 S.W.2d 297, (Tex. Ct. App. 1956) and *Horlock v. Horlock*, 533 S.W.2d 52 (Tex. Ct. App. 1976).

⁸⁹ *Sibley*, 286 S.W.2d at 659.

⁹⁰ *Id.* (citations omitted).

⁹¹ *Id.* For another article that reviews the Texas tracing cases in more depth, see Stewart W. Gagnon & Christina H. Patierno, *Reimbursement and Tracing: The Bread and Butter to a Gourmet Family Law Tracing Case*, 49 BAYLOR L. REV. 323 (1997).

⁹² In *Clark v. Boston-Continental Nat'l Bank*, 9 F. Supp. 81, 89 (D. Mass. 1934) a Massachusetts federal district court used this "trustee out first" rule in order to trace commingled trust funds in the hands of a receiver. The court stated, "[w]here one who stands in the position of a trustee mingles the trust res with his other funds, the law will presume that all withdrawals from the mingled account were first withdrawals against his own money, rather than against the trust fund." *Id.* As authority for this principle, the court cited to *Blumenfield v. Union Nat'l Bank of Beloit*, 38 F.2d 455 (D. Kan. 1930), *Dickson v. First Nat'l Bank of Buffalo*, 26 F.2d 411 (D. Okla. 1928), and *Fiman v. South Dakota*, 28 F.2d 776 (D. S.D. 1928).

trustee's funds have been exhausted. Under either name, this rule is the functional equivalent of the lowest intermediate balance rule, and is apparently adapted for this context. In the community property context, this cousin to the lowest intermediate balance rule seems well suited to recovering known separate contributions to commingled accounts.

A curious aside on this point is the fact that the Louisiana courts use this same principle in the reverse order. In *Reinhardt v. Reinhardt*,⁹³ the court, facing a segregation issue, explained that:

[W]hen separate funds are commingled are no longer capable of identification and it is impossible to trace the origin of the funds, then all the funds are considered community. Further, there is a "presumption that withdrawals from an account in which the community and separate funds are commingled are presumed to come first from separate funds."⁹⁴

This simple assumption radically alters the manner of tracing community property funds within commingled accounts in Louisiana. By simply shifting this presumption, the claimant of the separate property gains an advantage, given that the tracing fiction protects the separate funds as those remaining in an account and the assumption is that the spent funds were exhausted first.

While these principles work adequately with ideal facts, once the facts become complicated, they present more difficult issues. For example, imagine that ten creditors have loaned money to a debtor who is now in bankruptcy, and each creditor took separate collateral for its loan, such that each had first priority on his or her collateral. Next, suppose the debtor sold each creditor's collateral for \$1,000 and placed the proceeds (totaling \$10,000) into an account at various times; then, instead of paying the creditors, the debtor made withdrawals from the account for various purchases. While some of the purchases made from the proceeds in the account may be traceable, suppose that only \$1,000 remains in the account at the time of bankruptcy. Which of all these creditors will be entitled to the funds in this account? One could argue that, when the amounts of the funds are known, the *pro rata* hybrid of the lowest intermediate balance rule could be employed to divide up the funds among the creditors (an example of creative lawyering allowed by revised Article 9). But such arguments cannot bridge all of the likely gaps to be encountered by importing such cases into secured transactions. If the group of creditors includes the bank in which the account is maintained, it will most likely take all the funds, as that bank will have first priority in the deposit account under revised Section 9-104. The key takeaway from this example is that a simple tracing fiction like community-out first can probably only be used in conjunction with secured transactions when there are very few creditors and the priority issues do not present the problems in the foregoing example. However, there may be very simple cases where the community-out first principle – especially if used in tandem with some other equitable trust principle – may lend aid in an Article 9 context.

Tracing seems to have had quite an extensive history in California.⁹⁵ As the following discussion highlights, courts in California have discussed at least

⁹³ 728 So.2d. 503 (La. Ct. App. 1999).

⁹⁴ *Id.* at 507 (citation omitted). The court cited *Cutting v. Cutting*, 625 So.2d 1112 (La. Ct. App. 1993), writ denied, 631 So.2d. 453 (1994), as authority for this proposition.

⁹⁵ See *infra* notes 96-110 and accompanying text.

three different methods for tracing commingled funds from bank accounts, and it seems from the case law that all may be available in any given case. California courts seem to be willing to fashion a remedy from these differing methods in order to achieve justice among the parties, depending on the factual scenarios that present themselves in a particular case.

In an early case discussing the viability of tracing in California, *See v. See*,⁹⁶ divorcees of the *See*'s Candies distinction faced the dilemma of segregating their marital property. Each brought different theories to the table as to how this should be accomplished.⁹⁷ As the husband had kept two accounts, one containing separate funds and one with community funds, he argued (over his wife's objection) that, since he could prove that the amount of community expenses exceeded the amount of community income during the marriage, there could be no community property.⁹⁸ In other words, he sought to *recapitulate*⁹⁹ the earnings of the entire marriage in order to show, in the end, that there had been more community property expended than earned. Hence, the community, as the argument goes, could not have acquired the disputed assets.¹⁰⁰ The faulty logic of this recapitulation method was rejected by the California Supreme Court, which stated that one must prove the separate or community nature of the property *at the time it is acquired*, not by later showing that the community had a deficit in terms of overall earnings.¹⁰¹ Otherwise, the court stated, a spouse's interest that is believed to be community could later prove merely an "inchoate expectancy to be realized only if upon termination of the marriage the community income fortuitously exceeded community expenditures."¹⁰²

A later California decision, *Marriage of Mix*, faced a similar tracing issue; however, it allowed a slightly different method of tracing than the "recapitulation method," which had been rejected in *See*.¹⁰³ The *Mix* court cited *See* for the proposition that, when dividing the marital assets, the presumption of community property will apply to a particular property if a spouse *can* prove that the community property funds were not exhausted when that particular asset was acquired.¹⁰⁴ As a result, the court approved the exhaustion method, which was a more logical extension of *See*.¹⁰⁵ This method works on the presumption that, when either party decides to commingle separate property with community property in a community account without keeping records of their transactions, the presumption of separate ownership is construed against that party in favor of the community.¹⁰⁶ Under this method, if a party can prove the exist-

⁹⁶ 415 P.2d 776 (Cal. 1966).

⁹⁷ *Id.* at 782-83.

⁹⁸ *Id.* at 779.

⁹⁹ *Id.* at 783.

¹⁰⁰ *Id.* at 782.

¹⁰¹ *Id.* at 783.

¹⁰² *See v. See*, 415 P.2d at 782-83. For an article discussing the interplay of these California cases, see Linda Gach, *The Mix-Hicks Mix: Tracing Troubles under California's Community Property System*, 26 UCLA L. REV. 1231 (1979).

¹⁰³ 536 P.2d 479 (Cal. 1975).

¹⁰⁴ *Id.* at 483.

¹⁰⁵ *Id.* at 483-84.

¹⁰⁶ *Id.* at 483.

tence of community funds at the time of acquiring any asset (in other words, that the community funds had not been exhausted), then that asset will presumably be owned by the community.¹⁰⁷

California courts have also discussed another tracing method, involving less fiction than the exhaustion method, in *Hicks v. Hicks*.¹⁰⁸ In *Hicks*, the court allowed a husband to show evidence of the existence of separate funds in a bank account consisting of dividends, proceeds from the sale of separate property and loans secured with separate property collateral.¹⁰⁹ He then showed evidence of how these funds had been withdrawn in order to purchase property which, he argued, was separate.¹¹⁰ This “direct tracing” is fiction-less because it involves no presumption of ownership as does the exhaustion method; it apparently only requires good evidence and credibility as to the purchaser’s intent.

Since direct tracing is a method of tracing that exists in other areas of law – and is perhaps the most logical way of tracing (if one is able to carry the burden of proof with good records) – it brings little to the table in terms of new tracing ideas for Article 9. However, since the exhaustion method is willing to indulge in the presumption of a community property acquisition, perhaps it presents an idea that can be imported into some secured transactions contexts.

B. Tracing in the Bankruptcy Context

As in the case of community property law, bankruptcy is an area of law where tracing seems to be especially common. The reasons for the prevalence of tracing in the context of bankruptcy is obvious; as in a divorce, bankruptcy is a worst-case financial scenario for the entity that previously existed. Hence, it often becomes necessary to sort out financial interests as various parties go their separate ways in this context. In bankruptcy law, however, this “parting of the ways” between debtors and creditors is more complicated, since there is a trustee who also seeks to establish ownership to the property; as a result, the ability to legally capture collateral in these contexts is of paramount importance. Many different areas of law can be implicated in the context of bankruptcy tracings. Additionally, many of the tracing principles discussed previously may become relevant in these proceedings.

1. Common Secured Transaction

By way of introduction, it is best to start with a more common tracing situation in the bankruptcy context: a case where a secured creditor seeks to prove his right to collateral. In *Harley Davidson Motor Co. v. Bank of New England*,¹¹¹ Harley Davidson (together with ITT, a financial company) maintained a security interest in the entire motorcycle inventory of a motorcycle dealer.¹¹² The bank (Old Colony) that financed the dealer’s purchase of used

¹⁰⁷ *Id.*

¹⁰⁸ *Hicks v. Hicks*, 211 Cal. App. 2d 144 (1962).

¹⁰⁹ *Id.* at 157.

¹¹⁰ *Id.* at 157-58.

¹¹¹ 897 F.2d 611 (1st Cir. 1990).

¹¹² *Id.* at 613.

motorcycles maintained a junior security interest in the dealer's inventory.¹¹³ When the dealer declared bankruptcy, Harley (and ITT) alleged that Old Colony had interfered with its collateral by holding the title certificates to some of the motorcycles (which Old Colony had done in order to secure repayment of its loan).¹¹⁴ The plaintiffs argued that "the bank's practice caused the bankruptcy of the dealer, thereby preventing them from collecting all the money the dealer owed them and causing them to lose profits while they searched for a replacement dealer."¹¹⁵ Additionally, they alleged that the bank's practice of holding the certificates constituted conversion of the certificates and the proceeds of the cycle sales.¹¹⁶

The tracing issue arose in this case when Old Colony defended by arguing that the plaintiffs had no right to the *proceeds* from the sale of the cycle inventory, citing to a comment by Professor Gilmore.¹¹⁷ The comment indicated that, if the dealer had commingled the proceeds of the inventory with other funds of the dealer, they were no longer "identifiable," and the UCC did not allow recovery by a secured creditor.¹¹⁸ The court rejected this argument by pointing out that, while some early courts did follow Gilmore's view, it had long since been rejected by the courts.¹¹⁹ Additionally, the court pointed to the many courts that have adopted tracing principles in order to identify commingled proceeds.¹²⁰

2. Tax Trust Funds

A model case to demonstrate the prevalence of tracing principles in the bankruptcy context is *In re Megafoods Stores, Inc.*¹²¹ There, a bankrupt grocery store did not turn collected local sales taxes over to the state before filing for bankruptcy, but rather retained these funds in the store's general bank accounts, commingling them with other funds.¹²² The state comptroller asserted that a statutory trust should be imposed on these funds in an effort to exempt them from the bankruptcy estate under Bankruptcy Code §541.¹²³ The debtors disputed this assertion, arguing that, since the funds were commingled, they could not be traced and, hence, no trust could be imposed upon them.¹²⁴ Relying on the Supreme Court's decision in *Begier v. I.R.S.*,¹²⁵ the court explained that withheld tax funds may be placed in a tax trust. Further, such a trust may be imposed at the "time the . . . taxes are withheld."¹²⁶ As a result,

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Harley Davidson*, cited to in GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 27.4 at 736 (1965).

¹¹⁸ *Harley Davidson Motor Co. v. Bank of New England*, 897 F.2d 611, 619 (1st Cir. 1990).

¹¹⁹ *Id.* at 619-20.

¹²⁰ *Id.*

¹²¹ 210 B.R. 351 (B.A.P. 9th Cir. 1997).

¹²² *Id.* at 353.

¹²³ *Id.* at 354.

¹²⁴ *Id.*

¹²⁵ 496 U.S. 53 (1990).

¹²⁶ *Megafoods Stores*, 210 B.R. at 355.

segregation of the funds is not necessary for the imposition of such a trust.¹²⁷ However, in determining which funds the trust applies to, the court stated that “[t]he [Supreme] Court did not specifically address the issue of whether the [lowest intermediate balance rule] is a viable method of tracing when a trust is statutory in nature.”¹²⁸ Unable to find direction from the high court on the issue, the court then considered post-*Beiger* case law in the Ninth Circuit to determine that the lowest intermediate balance rule is “a viable method of tracing statutory trust fund taxes which had been in the debtor’s general accounts along with non-trust funds”¹²⁹

In re Megafoods is typical of bankruptcy disputes, since a trust device was used to restore property to the party entitled to those funds. Additionally, it demonstrates that other areas of law (i.e., tax law) are often implicated in these proceedings. Hence, there are multiple opportunities for tracing issues to present themselves in these cases, as indicated by *Harley*.

C. Trust Law, Property Law, and Bankruptcy

1. Constructive Trust

Another example of complex tracing issues in bankruptcy proceedings that implicate other areas of the law is *In re Handy & Harmon Refining Group*. In this case’s rarified fact pattern, the creditor (the United States Mint) of a debtor who filed for Chapter 11 protection sought to impose a constructive trust on the proceeds of the sale of a “metal pool” maintained by the debtor.¹³⁰ Specifically, the Mint had delivered to the debtor company a quantity of high-grade silver bullion for refining.¹³¹ The debtor typically received quantities of metal from customers and then either purchased the metal or simply returned the same amount to a customer.¹³² The Mint argued that, since the debtor maintained a metal pool for which it kept records of deposits and withdrawals, the situation was nearly analogous to a deposit account.¹³³ The Mint argued that, under this analogy, it should be able to trace the amount of the proceeds of the silver to which it was entitled through use of the lowest intermediate balance rule.¹³⁴ Since the amount of silver bullion ‘on deposit’ in the pool “never fell below the amount of silver underlying the Mint’s claim,” it was entitled to trace its ownership to the proceeds of the debtor’s pool.¹³⁵

This argument is somewhat exemplary of the type of analysis that the revised Section 9-315 has invited. It has borrowed a tracing principle from one area of law (tracing of deposit accounts and trust funds) to another (tracing of personal property in the form of a commingled mass), both of which have been described previously. Unfortunately, *Handy* does not extend hope to those who seek to emulate this type of reasoning-by-analogy, since the court rejected the

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at 357.

¹³⁰ 266 B.R. 24 (Bankr. D. Conn. 2001).

¹³¹ *Id.* at 26.

¹³² *Id.*

¹³³ *Id.* at 28.

¹³⁴ *Id.*

¹³⁵ *Id.*

Mint's theory. The court reasoned that, if it were to impose a trust on the silver-pool, it would have to do so for the benefit of all the consignors; none of the proceeds of the silver would constitute non-trust funds.¹³⁶ The court then explained that, since the lowest intermediate balance rule only applies when "trust funds are commingled with non-trust funds," the tracing approach could not apply in this situation to allow the Mint to trace its interest in the proceeds of the pool.¹³⁷ Again, this case demonstrates the difficulties that may arise when one tries to apply tracing principles created for one purpose in a wholly different context.

2. *Trust Accounting Variation of the Lowest Intermediate Balance Rule*

One variation of the lowest intermediate balance rule was explained in the context of a bankruptcy action in *Chrysler Credit Corp. v. Superior Court*.¹³⁸ In that case, a creditor (Chrysler) that held a security interest in the proceeds of an insolvent dealership's car sales sought to recover funds from a cash collateral account, where the funds had been transferred from the dealer's general operating account.¹³⁹ Since other creditors, also seeking the funds, proved that the dealer had commingled the funds with non-proceeds, they argued that Chrysler bore the burden of tracing the funds to show that they were identifiable.¹⁴⁰ These creditors argued that the lowest intermediate balance rule would not help Chrysler, since the account at issue was maintained at a zero balance, although collateral proceeds had once been deposited into the account.¹⁴¹ Therefore, argued the creditors, Chrysler had no claim to funds that were subsequently deposited but were not collateral proceeds.¹⁴² In response, Chrysler argued that an exception to the lowest intermediate balance rule should apply. The court explained this exception as follows:

It has been held that where a trustee commingles personal funds with trust funds, and dissipates the commingled funds such that the trust funds are affected, and then deposits additional personal funds into the account, it may be presumed that the trustee was intending to reimburse the trust funds. In such a situation, the trust funds will be replenished.¹⁴³

The principle Chrysler attempted to apply would have been a departure indeed from the lowest intermediate balance rule that, as has been discussed, is generally applied in a rigid manner.¹⁴⁴ The court was unwilling to adopt this exception to the general rule, reasoning that, "in our view this exception, if

¹³⁶ *In re Handy*, 266 B.R. at 29.

¹³⁷ *Id.*

¹³⁸ 17 Cal. App. 4th 1303 (1993).

¹³⁹ *Id.* at 1308-10.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 1316.

¹⁴² *Id.* at 1316-17.

¹⁴³ *Id.* at 1317. The court cited the following cases as authority for this proposition: *Mitchell v. Dunn*, 211 Cal. 126, 134 (1930); *Church v. Bailey*, 90 Cal. App. 2d 501, 504 (1949); and *In re California Trade Technical Schools, Inc.*, 923 F.2d 641, 646 (9th Cir. 1991).

¹⁴⁴ See *supra* notes 19-31 and accompanying text discussing *In re Oriental Rug Warehouse Club, Inc.*, 205 B.R. 407 (Bankr. D. Minn. 1997).

broadly applied, would completely emasculate the rule.”¹⁴⁵ It continued that the exception was “properly limited to contests between trustee and beneficiary, where the trustee essentially embezzles trust funds and subsequently intends to, and does, replace them.”¹⁴⁶

This “exception” to the lowest intermediate balance rule, which has been used in both California and the Ninth Circuit, is indeed groundbreaking for this inquiry.¹⁴⁷ It allows some of the rigidity of an important rule to flex in a situation where it would be equitable to do so, depending on the facts of a case. The fact that this court rejected the invitation to extend such a rule in the pre-revision days is perhaps less consequential now that the Section 9-315 liberally invites such arguments to be made.

3. *Banking Law, Including Lending, Trust, and Investment Company Law*

A situation similar to the exemption of the tax trust fund described in *Chrysler Credit* also arises in banking institution insolvency proceedings. The broad rule in such scenarios is that:

[W]here a trust fund has been converted by the trustee company or commingled with its other funds, the beneficiary is, where the beneficiary is able to trace it, under the general rules applicable to trusts, to the general funds of the bank in the hands of the receiver or liquidator, entitled to a priority or preference as to payment therefrom¹⁴⁸

This concept is discussed in various cases, such as *In re Arcadia Trust Co.*, wherein claimants were able to establish priority to trust funds upon the trust company’s insolvency, since the trust company had commingled the funds with other of the company’s funds.¹⁴⁹ A similar case arose in *Glidden v. Getalius*, which also discussed the manner in which the invested funds may be traced for the benefit of the beneficiaries.¹⁵⁰ The *Glidden* court stated that, “where the trustee fails and has insufficient assets to meet fiduciary and general obligations of such trustee, the preferences of the *cestui que trustent* are, as occasion requires, confined to the lowest cash balance on hand at any time after the trust funds were received”¹⁵¹ The court continued by explaining that this method should be used unless the invested funds may be directly traced into specific securities purchased and held by the trust company.¹⁵² As a result, it seems apparent that the lowest intermediate balance rule is required for the cash invested in these trusts.

¹⁴⁵ *Chrysler Credit*, 17 Cal. App. 4th at 1317.

¹⁴⁶ *Id.*

¹⁴⁷ *Mitchell*, 211 Cal. at 134; *Church*, 90 Cal. App. 2d at 504; *California Trade Technical Sch.*, 923 F.2d at 646 (9th Cir. 1991).

¹⁴⁸ 9 C.J.S. *Banks and Banking* § 645 (1996). The cited section cites to the cases discussed in this section; additionally, it cites cases from the following jurisdictions as authority for this rule: Arkansas, Florida, Indiana, Louisiana, New York, North Carolina, Ohio, and Pennsylvania.

¹⁴⁹ 268 N.Y.S. 759 (Sup. Ct., 4th App. Div. 1934).

¹⁵⁰ 120 So. 1 (Fla. 1929).

¹⁵¹ *Id.* at 2.

¹⁵² *Id.*

4. *Client Trust Funds*

A far less forgiving approach to trustee commingling is found in attorney discipline proceedings. In one such case, *Matter of Pomerantz*, the Supreme Court of New Jersey upheld the disbarment of an attorney who commingled various client funds with his own firm's funds, without keeping the records required by the state rules of professional responsibility.¹⁵³ As a result, the state ethics board recommended the attorney's disbarment.¹⁵⁴ While disbarment may not be a universal remedy for this kind of violation,¹⁵⁵ it is certainly indicative of the fact that, with some trust funds, commingling is not tolerated where very special fiduciary duties attach and, hence, the concept of tracing is moot.¹⁵⁶

5. *Association Trust Funds*

Another related principle that has a certain visceral appeal – at least to victims of clearly fraudulent commingling of funds – is the principle espoused by the court in *Smith v. Township of Au Gres*.¹⁵⁷ In that case, a town treasurer invested township funds into his own personal business, using these to purchase goods in clear violation of his duty to keep such funds separate.¹⁵⁸ Shortly thereafter, his creditors filed a petition to force him into bankruptcy.¹⁵⁹ Had there not been claims by other creditors, the court indicated that it would have been inclined to grant the township a lien on the commingler's entire stock of goods;¹⁶⁰ the court states that, “[w]here, as in this case, a wrongdoer knowingly mingles the property of another with his own in such manner that it becomes undistinguishable, the true owner *may claim the whole mass . . .* (emphasis added).”¹⁶¹ However, the court pointed out that, if the claim against the entire fund were for more than what the township lost, it would work a hardship upon the other creditors.¹⁶² As Professor Palmer points out, this view would most likely not be applied by courts today, as it would likely cause undue hardship to the guilty party.¹⁶³

¹⁵³ 714 A.2d 233 (N.J. 1998).

¹⁵⁴ *Id.*

¹⁵⁵ ROBERT H. ARONSON ET AL., *PROBLEMS, CASES AND MATERIALS ON PROFESSIONAL RESPONSIBILITY* 132 (2d ed. 1995). The authors indicate that, while most courts agree that disbarment is the appropriate remedy for knowing misappropriation of client trust funds, it is not necessarily the only remedy. *Id.* They cite to the fact that Section 4.1 of the ABA's “Standards for Imposing Lawyer Sanctions” does not take the “automatic disbarment” approach. *Id.*

¹⁵⁶ 355 N.E.2d 3 (Ill. 1976).

¹⁵⁷ 150 F. 257 (6th Cir. 1906), *cited in* PALMER, *supra* note 36, at § 2.13.

¹⁵⁸ *Id.* at 259.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 260.

¹⁶¹ *Id.* at 260-61.

¹⁶² *Id.* at 261.

¹⁶³ PALMER, *supra* note 36, at 169.

6. *Personal Property Law and Commingled Chattels: Approximate Correctness*

Personal property law dealing with commingled chattels would likewise seek to avoid an unnecessary hardship on the commingler. In *Somers v. Kane*,¹⁶⁴ the court stated that, although the defendant had wrongfully commingled the logs at issue, “there should not be so drastic a result as the verdict brings.”¹⁶⁵ The logs of the plaintiff could not be identified “log for log”¹⁶⁶ after their mingling with those of the defendant’s, but their relative amounts and value could be found with “approximate correctness.”¹⁶⁷ Perhaps influential in this more lax approach to the personal property situation is the fact that, under warehouseman law, it is generally understood that an owner’s commodity product, such as grains, will be mixed with grain of like kind when deposited for storage.¹⁶⁸ However, the *Somers* court also clarified that, in calculating this approximate amount, “every reasonable doubt is resolved in favor of the party wronged.”¹⁶⁹ Professor Palmer agrees that this method of approximation (borrowed from property law) reflects the changed attitude of the courts in dealing with commingled trust funds.¹⁷⁰

These “compromise” principles, where courts allow identification of property (through tracing) so that it can make a proportionate division, are capable of use in many areas of law.¹⁷¹ Whatever their appeal, cases like *Somers* are attractive to courts in part because they mitigate against the harsh effects of allowing an innocent party to claim an entire fund, so long as there exists a way to approximate or “trace” the innocent party’s share. This principle holds potential application in secured transactions, perhaps in some cases even as an

¹⁶⁴ 210 N.W. 287 (Minn. 1926), cited in CRIBBETT ET AL., PROPERTY, CASES AND MATERIALS 170 (7th ed. 1996).

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ See, e.g., *Central States Corp. v. Luther*, 215 F.2d 38 (10th Cir. 1954). See also 93 C.J.S. *Warehousemen and Safe Depositories* §14 (1996). An interesting aside addressing this point is found in the California bankruptcy case *In re California Pacific Rice Milling, Ltd.* 2001 Bankr. LEXIS 953 (Bankr. E.D. Cal. July 23, 2001). In this case, a rice farmer claimed a producer’s lien (under CAL. FOOD & AGRIC. CODE §§ 55631 and 55634) against the entirety of rice inventory in the possession of a grain processor (who stored the farmer’s rice), which had filed bankruptcy. *Id.* at 1-2. The court, however, noted that the farmer’s grain had only been commingled with rice of the same variety and crop year as his own. *Id.* at 2. As such, the court refused to grant a producer’s lien on the producer’s entire inventory, and held that such a lien could only extend to that rice with which the farmer’s rice had been commingled. *Id.* at 9-10. While this case does not discuss tracing principles, it is significant in that it creates a limitation on the total amount of the “fund” – or, in this case, stored rice – that can be traced in order to restore a creditor to its position prior to depositing its goods with the debtor.

¹⁶⁹ *Somers*, 210 N.W. at 288.

¹⁷⁰ PALMER, *supra* note 36, at 169.

¹⁷¹ An example of the breadth of this principle, as described by Palmer, is its use in copyright law. Early courts refused to attempt apportionment of profits when copyrighted information was incorporated into a work containing both original and copyrighted material. In more modern times, however, the Supreme Court has required apportionment, (as in *Sheldon v. Metro-Goldwyn Pictures Corp.*, 309 U.S. 390 (1939)) “despite the fact that anything like an exact apportionment was impossible.” PALMER, *supra* note 36, at 171-72.

alternative to the lowest intermediate balance rule. Such potential is especially poignant where the amount of money remaining in a commingled account is higher than what the lowest intermediate balance would yield. As previously mentioned, the lowest intermediate balance rule does not allow credit for deposits made after the account balance has sunk to its lowest amount. Yet the "approximate correctness" principle would essentially reject the fiction of identification through a rigid tracing principle in favor of a more equitable result, to be determined by the court on a case-by-case basis. This kind of principle could be implemented by a creditor like Bob, who would be able to estimate the amount of the proceeds of the sale of his collateral (the car which was wrongfully disposed of and whose proceeds were wrongfully commingled) that went into Andrew's account. This way, he could claim more of the fund than he would otherwise be able to claim through the lowest intermediate balance rule. The obvious weakness of this principle is that it could only be applied in very simple cases where few creditors could fight over the funds, and where the bank account does not act as collateral for any loan to the debtor. This deficiency results because, as the *Au Gres* case indicates, it would be inequitable to estimate the contribution of one secured creditor, construing the doubts against the commingler, if this allots money from the account to one creditor at the expense of others who would have claims thereon.¹⁷² In the commercial context, such cases are likely to be few and far between.

7. Estate Law: Wills and Will Substitutes

In reviewing cases involving estate instruments, courts typically have discussed the need for tracing in the context of ademption; in other words, a testator has bequeathed some specific property to an individual, who discovers after the testator has died that the property bequeathed no longer exists. A typical case is found in *In re Estate of Warman*.¹⁷³ There, a testator had bequeathed certain settlement proceeds to his wife; but, after making his will, the testator evidently invested these funds into other assets.¹⁷⁴ The widow brought the argument that she should be able to trace the settlement funds into the property subsequently purchased.¹⁷⁵ In this particular case, the court did not permit this kind of tracing, stating that "[t]o find otherwise would permit legatees of specific bequests of money to trace the money to any item purchased with the money by arguing that the new asset was simply an investment of the former."¹⁷⁶ While the results in such cases may diverge depending on the facts and equities, it seems clear that the courts have not added any new tracing principle in order to show whether or not ademption has occurred with respect to certain property.¹⁷⁷

A related case that involved a will-substitute, however, was decided in a manner similar to another type of case that this note has reviewed previously,

¹⁷² *Smith v. Township of Au Gres*, 150 F. 257, 261 (6th Cir. 1906).

¹⁷³ 682 N.E.2d 557 (Ind. Ct. App. 1997).

¹⁷⁴ *Id.* at 559-60.

¹⁷⁵ *Id.* at 560.

¹⁷⁶ *Id.* at 563.

¹⁷⁷ *See, e.g., In re Potter's Will*, 251 A.D. 679 (N.Y. 1937); *Estate of Mayberry v. Mayberry*, 886 S.W.2d 627 (Ark. 1994).

and indicates that estate law is capable of using tracing principles from other areas of law. In *Peterson v. Swan*,¹⁷⁸ a replevin action was brought by the mother of a deceased daughter against her son-in-law to recover certain bonds in which the mother was named as beneficiary.¹⁷⁹ The husband contended that the bonds were wrongfully purchased with joint funds, since the couple had voluntarily commingled their funds.¹⁸⁰ The court, accepting the husband's proof that the bonds were purchased with joint funds, held that "[t]he rule in this state is well-established that, where a wrongdoer uses money of another in the purchase of property in the name of a third-person, the owner of the money is entitled to enforce a constructive trust or equitable lien upon the property purchased."¹⁸¹ The court then stated a broad rule, similar to that in *Township of Au Gres, supra*, that even where the commingling is voluntary (not wrongful as in *Au Gres*), where one takes such joint funds and purchases property wrongfully, "if it is impossible to make an equitable division, the whole of the converted property should be held to be that of the party who has done no wrong."¹⁸² As a result, a tracing principle was applied in this case, where a will substitute was used to bequeath property. However, even though this case involved a will substitute, it appears that the court applied this rule, since it allowed the husband to impose a constructive trust on the property.¹⁸³ As a result, estate law really adds little to any discussion of which tracing principles may be borrowed into secured transactions law.

D. Criminal Law

1. Money Laundering and RICO Violations

Professors Kirk McCormick and Brian Steckloff discuss tracing in the context of money laundering prosecutions in their article on the subject.¹⁸⁴ Importantly, they note that 18 U.S.C. § 1956 provides that the government does not have to trace the source of laundered funds in order to charge a defendant.¹⁸⁵ Instead, they declare, the government need only "present evidence demonstrating that the defendant engaged in conduct typical of that type of criminal activity and had no other legitimate source of funds."¹⁸⁶ A similar result obtains in the case of RICO violations, where the government seeks to force the forfeit of proceeds of racketeering activity.¹⁸⁷

¹⁷⁸ 57 N.W.2d 842 (Minn. 1953).

¹⁷⁹ *Id.* at 845.

¹⁸⁰ *Id.* at 844-45.

¹⁸¹ *Id.* at 845.

¹⁸² *Id.* at 847.

¹⁸³ *Id.* at 845.

¹⁸⁴ Kirk McCormick & Brian Steckloff, *Money Laundering*, 37 AM. CRIM. L. REV. 729 (Spring 2000).

¹⁸⁵ See also *United States v. Pennington*, 168 F.3d 1060 (8th Cir. 1999).

¹⁸⁶ See McCormick et al., *supra* note 184, at 740-41.

¹⁸⁷ See, e.g., *United States v. Navarro-Ordas*, 770 F.2d 959 (11th Cir. 1985). In this case, the court upheld a forfeiture order against a defendant. Essentially, the court rejected an argument that, since the proceeds of the racketeering activity are not identifiable through direct tracing to specific assets, the government should not be able to forfeit the assets. *Id.* at 969. The court relied on the United States Supreme Court's precedent in *Russello v. United States*, 464 U.S. 16 (1983), which it claimed "controls this situation by analogy." The court

On the other hand, tracing does come into play if the government wants the defendant to forfeit the funds allegedly laundered or property allegedly purchased with laundered funds. As the professors summarize, "The government must prove, by a preponderance of the evidence, that the property it seeks has 'some nexus to the property 'involved in' the money laundering offense.'"¹⁸⁸ If a defendant has commingled legitimate and tainted funds, courts may still conclude that all funds in the account are subject to forfeiture. For example, in *United States v. All Funds Distributed to Edward Weiss*, the defendants ran a business (B.R. Ambulance Service, Inc.) that provided transportation to Medicare beneficiaries.¹⁸⁹ The government discovered that the owners of the business (Edward and Rosemary Weiss) had submitted both legitimate and fraudulent claims to Medicare for reimbursement over a four-year period.¹⁹⁰ BR had commingled the funds it received from these fraudulent claims with funds from legitimate claims. These funds were then used to run the business, as well as to fund a pension fund, of which the unscrupulous Weiss couple owned an eighty percent interest.¹⁹¹ When BR filed for bankruptcy, the pension fund was converted into a substantial amount of cash, which the Weisses invested in IRA accounts at a bank.¹⁹² The key issue in this case became whether the proceeds were "specific" and "identifiable," or whether they were "fungible" (as this determined the relevant statute of limitations).¹⁹³ The seizure of these accounts was ultimately denied by the courts because the seizure of the funds was time barred under 18 U.S.C. § 984(c).¹⁹⁴

2. *Embezzled Funds and Narcotics Proceeds*

*United States v. 170 Westfield Drive*¹⁹⁵ discusses a method of tracing laundered funds. In that case, the claimant's ex-husband, Robert Catalozzi, embezzled over a million dollars from the US Postal Service.¹⁹⁶ The money was then placed into Catalozzi's wife's company's checking account, which funds were then used by Catalozzi to buy certain parcels of real estate, including that utilized in the construction of a home.¹⁹⁷ Upon discovery of the crime, the federal government sought forfeiture of both the property and deposit

explained that the relevant forfeiture provisions of the United States Code did apply to forfeit profits of the illegal enterprise, as well as any interest therein. *Id.* at 970. As the Seventh Circuit explained in *United States v. Ginsburg*, 773 F.2d 798, 801, (7th Cir 1985), "RICO forfeiture [under 18 U.S.C. § 1963(a)(1) (year)] is a punishment imposed on a guilty defendant. It deprives that defendant of all of the profits or proceeds that he has acquired through racketeering activity, regardless of whether those assets are themselves "tainted" by use in connection with the illegal activity." Hence, it is clear that the government's tracing duty under the RICO forfeiture provision is very limited; it need only establish some limited tie of the funds or assets to the racketeering activity in order to forfeit these.

¹⁸⁸ See McCormick et al., *supra* note 184, at 742 (citation omitted).

¹⁸⁹ 2001 WL 1150217 at *1 (E.D.N.Y. Sept. 21, 2001).

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.* at 2.

¹⁹⁴ *Id.*

¹⁹⁵ 34 F. Supp.2d. 107 (D.R.I. 1999).

¹⁹⁶ *Id.* at 110.

¹⁹⁷ *Id.* at 110-111.

accounts into which these funds had been placed.¹⁹⁸ Since the court considered this money to be “mixed and moved” (in other words, commingled with the wife’s legitimate funds and then moved out of the account, as opposed to merely “mixed,” as is the case with simple commingling of legitimate and tainted funds where the funds remain in the same account), the court faced the dilemma of deciding whether it could forfeit the wife’s interest in the house and deposit accounts.¹⁹⁹

The court noted that there is a split in the federal circuits as to whether the government can trace the funds in an account in order to impose forfeiture in a case with “mixed and moved” money.²⁰⁰ The court explained that “the Third Circuit gives criminals the benefit of the doubt. It holds that the government must actually trace the untraceable. Because the government cannot prove that withdrawn money is actually illicit money, it cannot forfeit “mixed and moved” money as traceable.”²⁰¹ Choosing to side with those courts that allow tracing of such funds, that court noted that, in the Second Circuit, tracing of such funds is performed by use of a tool equivalent to the lowest intermediate balance rule.²⁰² It explained:

To trace the illicit money, the Second Circuit tapped a trusts doctrine known as the “lowest intermediate balance” analysis exemplified by this illustration: if \$100 from a drug sale is deposited into an active account, the proceeds in the account are “traceable” to the extent of \$100 as long as the balance never falls below that amount; the untainted money added to the account after the balance falls below \$100 is immune from seizure. The Second Circuit referred to this analysis as the “drugs-in – last out rule.” As to mixed money in a bank account, this Court broadens the “drugs-in – last out” into an “illicit-in – last out” rule. The government may forfeit the lesser of the illicit money or the lowest balance since the illicit money was deposited.²⁰³

Broadening this principle, as recognized by this court, becomes more difficult when the funds are “mixed and moved.”²⁰⁴ It is interesting to note how this court applied these trust principles – not only in this laundering context, but in illegal-drug sales proceeds forfeitures as well. Such application demonstrates how widely these “trust” principles may be applied throughout various areas of law. Again following the Second Circuit, the court explained that, when money is moved, courts have adopted the “drugs-in – first out” theory, which allows the government to “trace the illicit money into any withdrawal or purchase to the extent of the illicit deposits.”²⁰⁵ The rationale for this different method is an assumption that “the criminal left the legitimate money in the account.”²⁰⁶

It is interesting to see courts within these areas of law taking such divergent views of tracing in this context. Unfortunately for this inquiry, the principles that they have adopted for use in this context are the same generic trust law

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at 116-18.

²⁰⁰ *Id.* at 116-17.

²⁰¹ *Id.* at 117 (citing *United States v. Voight*, 89 F.3d 1050 (3d Cir. 1996)).

²⁰² *Id.* at 116.

²⁰³ *Id.* at 116 (citations omitted).

²⁰⁴ *Id.* at 116-117.

²⁰⁵ *Id.* at 117.

²⁰⁶ *Id.*

principles that have been explained in this paper, albeit with more descriptive titles for the genre of cases. Hence, these cases really appear to add little to our bank of "tracing principles" that can be adopted into secured transactions.

IV. CONCLUSION

It remains to be seen how courts will interpret the revised Section 9-315(b)(2) and whether they will do so in such a manner as to invite and/or allow for some of the creative lawyering that has been discussed in this note. As has been discussed, it may be that, with the multitude of cases to be heard, courts will have difficulty breaking with the lowest intermediate balance rule with which they seem so comfortable at present. While the extent of change is open to speculation, it is likely that the language in revised Article 9 will begin to have some effect on tracing in Article 9, whether that be in a subtle or substantial fashion, once practitioners realize the power that has been given to them under the revised law.

Clearly, the opportunity to use tools other than the lowest intermediate balance rule should be of sincere interest to any lawyer whose client stands to benefit from a good-faith argument for the application of one of the equitable tracing principles that have been described above. By far, the biggest challenge to those making these arguments will be working through the priority issues that will most certainly face the courts whenever the application of new principles is argued. As each case brings a new set of facts to the table, only time will tell whether courts will be able to square a particular set of facts with the various combinations of equitable principles enumerated in this note, and broaden the instances of tracing within the law of secured transactions.