Feature

KEY POINTS

- Clarification of the law in this area is welcome after decades of uncertainty. The Board's decision is, however, only persuasive and not binding in England.
- The decision that backward tracing is possible improves the position of victims of fraud and bribery, who often include financial institutions.
- However, the benefit to victims will come at the expense of unsecured and floating charge creditors. Viewed overall, the decision is marginally adverse to lenders.
- Moreover, the process of tracing will inevitably become more complex, because it will no longer involve a purely arithmetical exercise and will involve considering the wrongdoer's intention. This will, for example, hamper the day-to-day work of banks dealing with financial crime perpetrated by customers.

Author Roger Laville

Bankers take note: how the tracing process has become more complex

The Privy Council has recently endorsed the concept of backward tracing in *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35. This article explores the considerations behind that decision and discusses its ramifications.

TRACING

The concepts underpinning tracing were explained by Lord Millett in *Foskett v McKeown* [2001] 1 AC 102. Tracing is the task of identifying a new asset as substitute for the old. What is traced is not the assets themselves, but the value in the assets.

> "Tracing is thus neither a claim nor a remedy. It is merely the process by which a claimant demonstrates what has happened to his property … and justifies his claim that the proceeds can properly be regarded as representing his property."

Tracing is a manifestation of property law, not the law of unjust enrichment.

On a practical level, the tracing exercise involves the application of a number of rules which have been established over time by the courts. One such rule is the "lowest intermediate balance rule": if an account contains funds held on trust for the claimant, and the trustee spends some of those funds before later crediting the account with new funds, then the beneficial interest of the claimant will be limited to the lowest balance of the original trust funds. The trust does not attach to the new funds paid in. This rule was originally established in *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62.

The rule that tracing cannot operate through overdrawn accounts can be seen as an example of the lowest intermediate balance rule. When the account becomes overdrawn, its balance falls below zero, preventing any continuing tracing of funds through the account at all.

BACKWARD TRACING

The first case to address expressly the possibility of backward tracing was *Bishopsgate Investment Management Ltd v Homan* [1995] Ch 211. The applicant (BIM) was the trustee of pension funds misappropriated by Robert Maxwell. The funds had been paid into accounts in the name of Maxwell Communication Corporation plc (MCC) which were either overdrawn or became overdrawn. BIM sought an equitable lien over all of MCC's assets to secure a claim to the funds.

At first instance, Vinelott J considered whether BIM could assert proprietary rights to MCC's assets. He held that BIM could do so only to the extent that BIM could satisfy the rules of tracing, which did not permit tracing through an overdrawn account. However, he reserved the position if it could be shown that there was a particular connection between any misappropriation of BIM's money and the acquisition of an asset by MCC. He gave an example of this, which he called "backward tracing", where an asset was acquired by MCC with money borrowed with the intention that it would be repaid with money from BIM. An alternative possibility was where money from BIM was paid into an overdrawn account, reducing the overdraft and freeing up finance in order to buy an asset.

On appeal to the Court of Appeal, Dillon LJ declined to overrule the first instance decision that backward tracing would be allowed where a connection could be shown. Leggatt LJ, on the other hand, was clear that "there can be no equitable remedy against an asset acquired before misappropriation of money takes place". The third judge, Henry LJ, unhelpfully agreed with both other judges, thereby depriving the law of a majority decision.

There were similar divergent views about backward tracing in *Foskett v McKeown* in the Court of Appeal ([1998] Ch 265).

BRAZIL v DURANT INTERNATIONAL

Backward tracing was recently considered by the Privy Council in *Durant*. The case was an appeal from the Royal Court and the Court of Appeal in Jersey.

As in many tracing actions, the dispute arose from the dishonest acquisition of money; in this case a former mayor of a Brazilian municipality and his son (together the "Malufs") had received bribes in connection with road building projects. The claimants, the state of Brazil and the municipality concerned, sought to recover the bribe money.

The Malufs had procured that bribes totalling US$10.5m were paid to an account at a New York bank. The account was in the name of Chanani and controlled by the son. Payments totalling US$13.1m were made from the Chanani account to an account held in Jersey by the first defendant, Durant. Payments totalling US$13.5m were made from the Durant account to the Jersey-based account of the second defendant, Kildare. Both companies were under the practical control of the Malufs.

The claimants brought a claim against both defendants alleging that they were

constructive trustees in respect of US$10.5m. A tracing process was employed to show that the money received by Kildare could be identified with the proceeds of the bribery.

The only issue in the appeal to the Privy Council was the defendants' argument that their liability was limited to US$7.7m. There were two bases for this assertion.

- The last three bribery payments reached the Chanani account after the final payments from the Chanani account to Durant.
- On two occasions, the balance on the Chanani account was less than the amount which could be said to be the proceeds of the bribes. The lowest intermediate balance rule restricted the amount which could be traced through it.

The parties agreed that if either argument was correct, the claim would be limited to US$7.7m. The dispute squarely engaged the issue of backward tracing.

The lower courts held that backward tracing was conceptually possible. Without it, a sophisticated fraudster could defeat a tracing claim by ensuring that the debits were made to his account before any credits were made from the proceeds of fraud. Whether backward tracing should be allowed depended on whether there was a sufficient link between the credits and the debits. In this case, the defendants had admitted a link between the credits and debits, albeit they maintained at first instance that the funds related to legitimate transactions.

THE ACADEMIC DEBATE

The dearth of previous authority led to the Board giving significant consideration to academic writings.

Support for backward tracing is lent by a paper by Professor Lionel Smith entitled 'Tracing into the Payment of a Debt' [1995] CLJ 290. In this article, which was written shortly after the Court of Appeal decision in *Bishopsgate*, he referred to several cases which he maintained were examples of backward tracing.

Smith also used a fictional scenario where a thief acquires a new car on credit from a seller, and then a day later pays the seller with stolen money. He argued that the money can be traced to the car in precisely the same way as if the car had been bought outright with stolen money. It is uncontroversial that from the seller's perspective it would be possible to trace from the money to the car, and "if from one perspective the money is the proceeds of the car, it follows that from the other perspective, the car is the proceeds of the money". Backwards tracing is just a matter of symmetry.

In an article entitled 'Difficulties with tracing backwards' (2011) 127 LQR 432, Professor Matthew Conaglen responded to Smith's paper. Conaglen argued that the cases relied upon by Smith did not show that backward tracing had been recognised by the courts. Moreover, he disagreed with Smith's car example, explaining that there is no symmetry between the seller and the thief; while the debt is an asset from the perspective of the seller, it is a liability from the perspective of the thief. In the absence of case law or a convincing argument from principle, whether the law should recognise backward tracing is a matter of legal policy.

Conaglen argued that in deciding whether to allow backward tracing, the law must strike a balance between the rights of creditors and the rights of the tracing claimant:

> "The unsecured creditors should not have their position worsened further by effectively making them insurers for the beneficiaries against trustee defalcations."

THE PRIVY COUNCIL DECISION

The Board's judgment in *Durant* was given by Lord Toulson.

He commented that the defendants' two arguments were effectively different sides of the same coin. The lowest intermediate balance rule was a recognition that if the original property has been dissipated, it cannot be transformed into an interest in substitute property. Similarly, a property interest cannot turn into an interest in something which the holder already has, since the later acquisition cannot be the source of the earlier.

Lord Toulson reviewed the previous English case law, in particular *Bishopsgate*, and observed that it was inconclusive. He also referred to Conaglen's paper and noted that it gave no reason why backwards tracing was conceptually impossible, agreeing that the question was in the end one of legal policy.

He ultimately founded the Board's judgment on a Canadian case, *Agricultural Credit Corpn of Saskatchewan v Pettyjohn* (1991) 79 DLR (4th) 22, a decision of the Saskatchewan Court of Appeal. It involved farmers who had purchased cattle on bridging finance and then used a term loan, secured over the cattle, to repay the bridging loan. The farmers became bankrupt. In order for the security for the term loan to be valid, the applicable statute required the second lender to show that its money was used to pay for the cattle. The Saskatchewan court held that in reality it was, even though the cattle were acquired before the loan was made.

The correct approach, Lord Toulson concluded, was to look at the substance of the transaction overall, rather than considering each step in it. In order to counter sophisticated money laundering, the court should not "allow a camouflage of interconnected transactions to obscure its vision of their true overall purpose and effect".

The Board therefore rejected the argument that it is never possible to trace backwards or through an overdrawn account. However, to do so the claimant must establish a co-ordination between the depletion of the trust fund and the acquisition of the asset looking at the transaction as a whole. The defendants' appeal was dismissed.

COMMENTARY

The Board's decision is not binding on English courts, but is highly persuasive and is likely to guide their approach to future cases. With this in mind, a number of issues arise for discussion.

Alternative remedies

Conaglen refers to other legal doctrines which might give the claimant the result he seeks without relying on backward tracing. Taking Smith's car example, if stolen monies are used to pay the seller, then the claimant might be subrogated to the rights of the seller, which may include express security rights over the car or an implied lien pending payment. This subrogated right would be an

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example of restitution for unjust enrichment.

Alternatively, stolen monies might be used to reduce the debt on an overdrawn account, freeing up borrowing capacity within an agreed overdraft limit and enabling the thief to draw on the account to purchase the car. In this case, it might be possible to argue that the stolen monies can be traced into the right to borrow more money (see the Supreme Court decision in *JSC BTA Bank v Ablyazov* [2015] UKSC 64 at para 37), and thence to the car.

It is important for the claimant to consider such options as well as tracing.

Co-ordination

Some uncertainty arises from the "co-ordination" control mechanism.

What amounts to "co-ordination" sufficient to allow backward tracing? Paragraph 34 of the judgment also refers to "a close causal and transactional link"; does this mean "but for" causation itself is sufficient, or is there also a remoteness element to the test such as a requirement for transactional closeness?

Co-ordination suggests an intentional plan, but whose intention must be evidenced? The judgment indicates that it is necessary to consider the intention of the thief, although it recognises that in many situations this will need to be inferred from other evidence. If so, does a lack of intention (for example where the thief mistakenly pays the creditor from the wrong account) destroy tracing rights?

We can hope that these questions will be answered in future decisions.

Tracing and restitution

We have recently seen a development of the principles applying to claims for restitution for unjust enrichment of an indirect recipient.

A restitutionary claim is usually a personal claim rather than a proprietary claim, conferring no priority over creditors.

The Court of Appeal in *Relfo Ltd v Varsani* [2014] EWCA Civ 360 explained the circumstances in which it is possible to claim restitution against an indirect recipient of benefits from the claimant. The approach in Relfo has subsequently been endorsed by the Supreme Court in *Bank of Cyprus UK Ltd v Menelaou* [2015] UKSC 66. Like *Durant*, *Relfo* was also a tracing case and the decision is pertinent to restitutionary claims against the ultimate recipient of laundered money.

Relfo decided that the causation threshold is a "but for" test: the claimant must show that but for the claimant's actions, the defendant would not have been enriched. But the law additionally considers remoteness. The restitution claim is not too remote if:

(i) the defendant is a direct recipient;
(ii) benefits can be traced from the claimant into the hands of the defendant; or
(iii) there is a "sufficient link" based on the "economic reality" of the dealings by the claimant and the enrichment of the defendant.

The formulation of limb (iii) appears to mirror Lord Toulson's test for tracing. However, this limb is only supposed to apply where limb (ii) does not apply: where there is no tracing. This might suggest that as a consequence of *Durant* limbs (ii) and (iii) will be merged and therefore that remoteness in restitution will be delineated simply by what can be traced.

However, Lord Millet made it clear in *Foskett* that tracing is based on property rights not unjust enrichment, so one would not expect them to overlap entirely. Moreover, according to *Foskett*, causation is irrelevant to tracing (since it is a process and not a claim), whereas the *Durant* formula is based firmly on causation considerations.

Does this indicate that the law of tracing is moving away from Lord Millett's formulation in *Foskett*? This seems unlikely given that *Foskett* was referred to with approval in *Menelaou*. In any event, it is now less clear where tracing ends and restitution begins.

The position of creditors

It is uncontroversial to recognise backward tracing to the detriment of the thief. However, in many cases, the thief is insolvent and the court's role is to balance the rights of innocent beneficiaries and innocent creditors.

Conaglen argues this consideration is determinative of the question: backwards tracing should be disallowed as a matter of policy because there is no reason to prefer beneficiaries to creditors. However, this is only a good argument if backward tracing goes beyond the vindication of property rights. If the tracing claimant is claiming his own property, this is in itself a reason why he should take priority to creditors, in backward tracing as much as conventional tracing. On the other hand, if by permitting backward tracing the law allows the claimant to exceed his proprietary rights, then Conaglen's argument holds good.

This issue is not tackled in *Durant*. The defendants do not appear to have been insolvent, and so the success of the tracing claim disadvantages the Malufs rather than any innocent creditors. The Royal Court expressly recognised this in its decision. Lord Toulson, however, places no limit on backward tracing, other than where a payment is made in anticipation of insolvency.

This issue is certain to come to the fore in subsequent cases.

CONSEQUENCES FOR LENDERS

This decision may prove difficult for lenders. Most obviously they will be disadvantaged as unsecured or floating charge creditors where beneficiaries take priority to their interests. But these occasions are likely to be relatively rare.

There are less obvious consequences. For example, banks are increasingly having to grapple with the difficulties caused when customers pass the proceeds of crime through their accounts. In order to resolve the problems and disputes that arise, they often rely on tracing processes to separate clean and dirty money. If tracing now involves considering the intention of the wrongdoer, then it is unlikely that banks will be able to do this without involving the courts, which will impede these processes and incur costs. ■

Further Reading:

- The vindication of an owner's rights to intangible property [2013] 7 JIBFL 412.
- Indirect unjust enrichment: theoretical elegance or robust pragmatism? [2014] 5 CRI 184.
- LexisPSL: Banking & Finance: Restitution, proprietary claims and tracing in a banking context – overview.