

# A big step forwards for backwards tracing

*A review of a recent Privy Council ruling that relaxes the restrictions on recovering fraudulent payments through backwards tracing*

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## Abstract

- The Privy Council has determined that fraudulent payments may be recovered through ‘backwards tracing’, as long as the court is satisfied that the transactions are part of a coordinated scheme.
- Where coordination is demonstrated, it should not matter whether a debit appears in a bank account before the corresponding credit entry, or whether the account is overdrawn or in credit.
- This decision will be welcomed by victims of fraud, as it expands the routes of asset recovery. Victims of fraud must ensure they seek legal advice promptly to maximise their chances of recovery through the civil courts.
- The Privy Council’s decision is not legally binding but it sets a persuasive precedent in English and Welsh law, which, in practice, will be treated as binding in England and Wales (and Northern Ireland).

**Tracing and following** are tools of evidence. They are mechanisms by which a claimant is able to identify a misappropriated asset and prove a claim to it, even though that asset may have undergone a change of form. However, the two mechanisms serve different purposes. Which is relevant depends on what has happened to the asset since its misappropriation:

- Following is the process of identifying the same asset as it passes unaltered through different pairs of hands. For example, if A takes B’s car and gives it to C, B can follow his car into the hands of C.

- Tracing is the process of identifying a new asset as a substitute for the old.<sup>1</sup> For example, if C gave A GBP5,000 for a car taken from B, B could choose not to follow the car to C but to trace into the GBP5,000 proceeds in the hands of A. B is able to do this because tracing follows the ‘value’ of an asset, rather than the asset itself.<sup>2</sup> Strictly speaking, tracing and following are neither claims nor remedies, although historically there has been a tendency to speak of them as such.<sup>3</sup> They are evidence-gathering processes employed to prove a claim and seek a remedy.

1. *Foskett v McKeown* [2001] 1 AC 102, at 127

2. *Ibid*

3. See *Commercial Fraud in Civil Practice*, 2nd ed, at 16.05–16.08

## EQUITY VERSUS COMMON LAW

Strict rules govern following and tracing. However, for historical reasons, these rules differ depending on whether the claimant's interest is equitable or legal. The primary difference is that equity allows money to be traced through a mixed fund, whereas the common law does not.<sup>4</sup>

This distinction is less meaningful than it once was, as the circumstances in which a claimant can establish equitable title have increased, allowing more claimants to benefit from the greater flexibility of the equitable rules. If the claimant can demonstrate that the asset was held under a fiduciary relationship prior to the misappropriation (for example, where the asset was held under trust), this will be sufficient equitable title. Alternatively, in circumstances where no such fiduciary relationship existed, it is sufficient for the claimant to demonstrate that the asset was lost due to theft, fraud or mistake. Such circumstances are of themselves deemed to create sufficient equitable title.<sup>5</sup>

The distinction between the common law and equitable rules has been greatly criticised, including by members of the judiciary, and calls have been made for a single unified set of rules.<sup>6</sup> Whether the Supreme Court will implement this remains to be seen. For our present purposes, we are concerned solely with the equitable rules of identification, specifically in relation to tracing.

## EQUITABLE RULES OF IDENTIFICATION

Generally speaking, once the claimant has successfully followed and/or traced the misappropriated asset or its proceeds, they may choose the type of claim to bring, whether personal or proprietary, and who to bring it against. Proprietary claims are often preferred as they have the benefit of ensuring priority over other creditors as regards the asset. This is important if there is any risk of the fraudster becoming bankrupt or the company going into administration.

But the equitable rules of identification are not unlimited in scope. A claimant cannot bring a proprietary claim against a bona fide purchaser for value without notice, nor can they bring a proprietary

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claim against a fraudster in circumstances where their proprietary interest has been extinguished.

So in what circumstances is a proprietary interest extinguished? The general rule of thumb is that, if the asset is used to discharge a debt, the claimant's proprietary interest in the asset is extinguished and they will be unable to trace any further.<sup>7</sup> For example, where money is paid into a bank account that is overdrawn by more than the amount paid in, the claimant will be prevented both from tracing any further and from bringing a proprietary claim in respect of the money. This is subject to circumstances where the debt is secured (e.g. a mortgage over property), as the claimant may be able to enforce against the security (i.e. the property) for the value of the misappropriated asset.

An extension of the general rule against tracing into a debt is the rule against tracing into non-chronological transactions. The courts have traditionally held that, where the claimant's proprietary interest has ceased to exist, it cannot be substituted for an interest in another asset acquired by the fraudster before the misappropriation, nor can it be transformed into an asset that the fraudster acquires at a later point. Where the claimant wishes to trace into an asset which the fraudster had previously acquired, the process is known as ‘backwards tracing’. As demonstrated below, increasing pressure has been placed on the courts to revisit the rule against this type of tracing.

## BACKWARDS TRACING

The argument against backwards tracing was summed up by Leggatt LJ in *Bishopsgate Investment Management Ltd v Homan*, who found that equitable tracing is not able to pursue monies through a bank account that is overdrawn at the time of payment, or later becomes overdrawn:

4. *Taylor v Plumer* (1815) 3 M&S 562

5. See *Lewin on Trusts*, 19th edn, 7.028–7.029

6. *Foskett v McKeown* [2001] 1 AC 102, at 128

7. See *Commercial Fraud in Civil Practice*, 2 edn, at 16.141

‘... there can be no equitable remedy against an asset acquired before misappropriation of money takes place, since *ex hypothesi* it cannot be followed into something which existed and so had been acquired before the money was received and therefore without its aid’.<sup>8</sup>

Leggatt LJ’s views on the possibility of backwards tracing leave no room for doubt. However, they were not unanimously shared by the other judges in the case. Both Vinelott J in the High Court and Dillon LJ in the Court of Appeal acknowledged the potential for backwards tracing in certain circumstances, such as where a connection could be shown between a particular misappropriation and the acquisition of a particular asset.<sup>9</sup>

A few years later, this position was further developed by Sir Richard Scott VC in *Foskett v McKeown*, who commented:

‘The availability of equitable remedies ought, in my view, to depend upon the substance of the transaction in question and not upon the strict order in which associated events happen... I do not regard the fact that an asset is paid for out of borrowed money with the borrowing subsequently repaid out of trust money as being necessarily fatal to an equitable tracing claim by the trust beneficiaries. If, in such a case, it can be shown that it was always the intention to use the trust money to acquire the asset, I do not see why the order in which the events happen should be regarded as critical to the claim.’<sup>10</sup>

Further argument for allowing backwards tracing has come from Professor Lionel Smith, who reasons that, in circumstances where a fraudster applies misappropriated money to discharge a debt, there is no logical reason for preventing a claimant from tracing into whatever was acquired in return for the incurring of that debt.<sup>11</sup> Professor Smith’s argument is particularly powerful in the context of the ever-more sophisticated techniques of money laundering, in which fraudsters use complex networks of debits and credits to obscure the relationship between transactions.

Despite various criticisms of the barrier against backwards tracing, it remained in force until very recently, when it was revisited by the Privy Council in *Brazil v Durant*.

## **BRAZIL V DURANT**

*Brazil v Durant International Corp* concerned an appeal to the Judicial Committee of the Privy Council by two BVI companies against a decision of the Jersey courts.<sup>12</sup> The Privy Council acts as the highest court of appeal for several independent Commonwealth countries, including Jersey.

The facts were as follows: over the course of January and February 1998, 15 secret payments were paid to Mr Paulo Maluf, former mayor of the municipality of Sao Paulo, Brazil (the municipality), in connection with a major road-building contract. The Jersey courts determined that these 15 payments were bribes.

Thirteen of these payments, totalling around USD10.5 million, were then transferred to an account in New York in the name of ‘Chanani’. This account was controlled by Mr Paulo Maluf’s son, Mr Flavio Maluf. From there, the monies were redistributed in ten payments to accounts in Jersey controlled by two BVI companies: Durant and its wholly owned subsidiary Kildare (the companies). The companies were both under the practical control of Mr Paulo Maluf at the time these events took place.

Having traced the bribe money to the companies, the municipality sought a declaration in Jersey that the companies were constructive trustees of the USD10.5 million, and liable for the return of the money to the municipality. The companies accepted liability in the Jersey courts for USD7.7 million, but denied that any more of the bribe money could be legally traced to them.

The companies’ argument that they only were liable for USD7.7 million had two limbs:

- that the last three payments into the Chanani account in New York occurred after the final payment to the Jersey company accounts. The companies submitted that these three later payments could not, therefore, be traced to them, as there is no sound doctrinal basis for ‘backwards tracing’.
- that the Chanani account in New York was a mixed account, holding funds other than the bribe money. The companies submitted that any monies paid out of the New York account that were greater than the bribe monies previously paid into it must, therefore, have come from other sources.

8. *Bishopsgate Investment Management Ltd (in Liquidation) v Homan* [1995] Ch 211, at 221

9. *Ibid.*, at 216

10. *Foskett v McKeown and Others* [1998] Ch 265, 283–4

11. ‘Tracing into the Payment of a Debt’ (1995) 54 CLJ 290; *The Law of Tracing* (1997)

12. [2015] UKPC 35

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The Privy Council dismissed the appeal of the companies.

The Privy Council was cautious about expanding the equitable principle of tracing too far and allowing as a ‘general application’ that ‘money used to settle a debt can in principle be traced into whatever was acquired in return for the debt’.<sup>13</sup> Nonetheless, the Privy Council accepted that there ‘may be cases where there is a close causal and transactional link between the incurring of a debt and the use of trust funds to discharge it.’ Further, the Privy Council stated that:

‘The development of increasingly sophisticated and elaborate methods of money laundering, often involving a web of credits and debits between intermediaries, makes it particularly important that a court should not allow a camouflage of interconnected transactions to obscure its vision of their true overall purpose and effect. If the court is satisfied that the various steps are part of a coordinated scheme, it should not matter that, either as a deliberate part of the choreography or possibly because of the incidents of the banking system, a debit appears in the bank account of an intermediary before a reciprocal credit entry’.<sup>14</sup>

The Privy Council determined that the proper approach to tracing was one that concentrated on the substance of the transaction in question and not on any strict order of events:

‘The Board therefore rejects the argument that there can never be backward tracing, or that the court can never trace the value of an asset whose proceeds are paid into an overdrawn account. But the claimant has to establish a coordination between the depletion of the trust fund and the acquisition of the asset which is the subject of the tracing claim, looking at the whole transaction, such as to warrant the court attributing the value of the interest acquired to the misuse of the trust fund. This is likely to depend on inference from the proved facts’.<sup>15</sup>

The consequence of *Brazil v Durant* is, it would appear, that fraudulent payments may be recovered

through backwards tracing, as long as the courts are satisfied that the transactions are part of a coordinated scheme. However, we eagerly await clarity as to how far the equitable principles of backwards tracing will be pushed in reality and what the words ‘coordinated scheme’ actually mean in practice. Only time will tell.

### **BENEFITS FOR VICTIMS OF FRAUD**

The Privy Council’s ruling in *Brazil v Durant* is not legally binding, but it sets a persuasive precedent in English and Welsh law, which, in practice, will be treated as binding in England and Wales (and Northern Ireland).

This decision will be welcomed by victims of fraud and those employed in the pursuit of fraudsters. The availability of backwards tracing as a method of asset recovery, depending on the facts of the case, will expand victims’ routes to recovering misappropriated assets and improve the likelihood of fraudsters being brought to justice.

Furthermore, the Privy Council’s recommendation that the specific facts of each case should determine the availability of backwards tracing is likely to provide the courts with increased flexibility, allowing unjust decisions to be avoided. In an era of rapidly evolving techniques for money-laundering and fraud, it is sensible for the law to be similarly agile.

As a consequence of the availability of backwards tracing being fact-specific, it is likely that the outcomes of future tracing cases will be difficult to predict. Accordingly, any victims of fraud should seek the advice of specialist civil-fraud solicitors without delay if they are to maximise their chances of benefiting from the equitable doctrine of tracing. Failure to do so promptly may prejudice a victim’s ability to recover stolen monies that have passed through various bank accounts or been used to buy new assets. Now, more than ever before, victims need to take control of the recovery of their assets, or potentially face losing out completely.

13. *Brazil v Durant* at 33

14. *Ibid.*, at 38

15. *Ibid.*, at 40

**DISADVANTAGES FOR CREDITORS**

While this decision may be welcomed by victims of fraud, there is a clear disadvantage to creditors in that it expands the possible circumstances in which a claimant will be able to assert priority by means of a proprietary claim. This is not necessarily an issue for creditors where the defendant is solvent, but, in circumstances where the claim is brought against an insolvent party, it may reduce the asset pool available to unsecured creditors.

The potential unfairness of backwards tracing to unsecured creditors was acknowledged by the Privy Council:

‘The courts should be very cautious before expanding equitable proprietary remedies in a way which may have an adverse effect on other innocent parties. If a trustee on the verge of bankruptcy uses trust funds to pay off an unsecured creditor to whom he is personally indebted, in the absence of special circumstances it is hard to see why the beneficiaries’ claim should take precedence over those of the general body of unsecured creditors.’<sup>16</sup>

However, the Privy Council decided that the balance between the interests of claimants and unsecured creditors could properly be addressed by analysis of the transaction as a whole, and by the requirement that there be ‘evidence of an overall transaction embracing the coordinated outward and inward movement of assets’.<sup>17</sup>

Creditors can minimise the risks by carrying out careful due diligence before entering into commercial transactions and, where appropriate, ensuring their debt is secured. From the perspective

of the fraud victim, this ruling stops creditors being able to benefit from the actions of the fraudster at the cost of the victim.

**IMPLICATIONS FOR TRUSTEES**

What does all this mean for trustees? Although the full implications of *Brazil v Durant* remain to be seen, trustees would be advised to take note of the decision, as there is the possibility that it may lead to increased litigation against trustees and fiduciaries.

In particular, without any clear direction from the courts yet as to what constitutes a coordinated scheme, particular caution should be exercised in any transactions involving trust assets. It is of vital importance that trustees undertake appropriate due diligence to understand the origin of monies paid into the trust account and the business of the settlor. In particular, trustees should ensure that the decision-making process behind any transaction is fully documented and explained, particularly if it involves large payments being made to and from the trust account. This should help to minimise the likelihood of disputes with beneficiaries further down the line.

When in any doubt, or before entering into any large or complicated transactions involving trust assets, trustees are advised to seek specialist legal advice, especially as most trust instruments allow trustees to incur legal fees at the expense of the trust where it is appropriate.

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16. *Ibid*, at 33. Also see Professor Matthew Conaglen’s article ‘Difficulties with tracing backwards’ [2011] 127 LQR 432, in which he argues that the courts should not worsen the position of unsecured creditors by permitting backwards tracing

17. *Ibid*, at 41