

October 28, 2015

In a landmark ruling the Judicial Committee of the Privy Council (the court of final appeal for the UK overseas territories and Crown dependencies) has, for the first time, allowed the equitable process of tracing to be extended to include 'backwards tracing'. This gives claimants a potentially powerful new tool to recover funds from fraudsters who seek to hide illegitimate funds beyond the reach of traditional tracing.

*"Tracing is neither a claim nor a remedy. It is merely a process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can properly be regarded as representing his property."* – *Foskett v.*

*McKeown*<sup>1</sup>. The courts have developed rules to determine in what circumstances this can occur. The court will start with the original property and follow what has become of it. Difficulties arise when the property in question 'disappears' during the tracing process. The concept that *"nothing comes from nothing"* is well established under English law. Thus, in circumstances where an asset apparently turns into something which the holder already has it has been argued that tracing cannot take place. This is a scenario in which the 'no backward tracing principle' has in the past been held to be applicable.

However, in the judgment in *The Federal Republic of Brazil and ors. v Durant International Corporation and ors.*<sup>1</sup> handed down on 3 August 2015, the Privy Council recognised the legitimacy of backwards tracing in certain circumstances. The Privy Council commented that the development of increasingly sophisticated and elaborate methods of money laundering, often involving a web of credits and debits between intermediaries, made it particularly important that the courts should not allow a camouflage of interconnected transactions to obscure their vision of their true overall purpose and effect.

## Facts

In 1998 Mr Maluf, the then mayor of Sao Paulo, received secret payments amounting to US\$10.5 million representing bribes in connection with a major public road building contract. There followed a chain of payments, illustrated in the diagram below, that ended with US\$13.5 million deposited in a bank account held by the BVI company Kildare.

The plaintiff, the Municipality of Sao Paulo, brought a claim against two British Virgin Island companies, Durant and Kildare (the "Companies"), that were both under the control of Mr Maluf and his son at the relevant time. The Royal Court held that the Companies were liable to the Municipality as constructive trustees of US\$10.5 million that represented the bribes to Mr Maluf. The findings of fact by the Royal Court were not challenged but the Companies appealed on the basis that the total amount that could be properly traced to them from the bribes was limited to US\$7.7 million.

The appellants argued that only US\$7.7 million of the US\$10.5 million could be identified in the Companies' accounts. The last three payments into Account No. 1 were made *after* the final payment from Account No. 1 to Account No. 2 (the Durant account) and, as there was no doctrine of backwards tracing, those three payments could not be traced through to Account No. 3 (the Kildare account).

Secondly, the Companies argued that Account No. 1 was a mixed account and that the amount the claimant could recover must be limited to the maximum that could be regarded as representing his money, known as *"the lowest intermediate balance rule"*. On two occasions payments were made from Account No. 1 to Account No. 2 which exceeded the maximum that could be said to have come from the bribes received by Mr. Maluf.

## Judgment

The Privy Council noted that the appellants' argument was coherent and supported by a good deal of authority. However, the Privy Council ultimately rejected the argument put forward in this case that there could never be backwards tracing.

The Privy Council held that, in order to deploy backwards tracing, a claimant had to establish co-ordination between the depletion of the trust fund and the acquisition of the asset which was the subject of the tracing claim, looking at the whole transaction. In this case, the court noted that it was the appellants' own pleaded case that all the relevant payments into Account No. 2 were linked with one another, allegedly as commission earned on a transaction, as well as with the payments into Account No. 1, and that the link between Account No. 2 and Account No. 3 could not be plainer. As the linking was so apparent in this case, the court did not give a detailed assessment of what might adequately evidence a 'co-ordinated scheme'. The Privy Council remarked that, if the court was satisfied that various steps were part of a co-ordinated scheme it should not matter whether that was a deliberate part of the choreography or the result of the incidents of the banking system, in which a debit appeared in the bank account of an intermediary before a reciprocal credit entry.

The Privy Council commented that this assessment was likely to depend on inference from the proved facts (particularly since in many cases the evidence of a (constructive) trustee would be of little value). In this case there was sufficient evidence to establish a clear link between the credits and debits taking place between the accounts. Thus the Privy Council was satisfied that the US\$10.5 million could and should be equitably traced through to Account No. 3.

## Comment

Although not binding on the English courts, the Privy Council's decision is highly persuasive, as the same judges sit on the English Supreme Court, and, it may be assumed, will now aid any claimant seeking to apply backwards tracing. In particular the Privy Council emphasised the court's discretion in its application of an equitable process. The judgment highlighted Sir Richard Scott VC's observation in *Foskett v McKeown*<sup>2</sup>; that "*the availability of equitable remedies ought to depend on the substance of the transaction in question and not upon the strict order in which associated events happen*".

For, as the Privy Council said:

*"The development of increasingly sophisticated and elaborate methods of money laundering, often 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."*

This decision is helpful for claimants seeking to persuade the courts to allow backwards tracing to stop sophisticated fraudsters defeating an otherwise effective tracing claim simply by manipulating the sequence in which credits and debits were made to their account. Claimants seeking to use backwards tracing will need to show strong evidence that, overall, the series of transactions was aimed to coordinate the outward and inward movement of assets.

The decision also adds to a number of recent judgments, such as *HR European Ventures LLP & ors v Cedar Capital Partners LLC*<sup>3</sup> and *Credit Agricole v Papadimitriou*<sup>4</sup> (see our briefing on this decision [here](#)), which highlight the proactive stance the courts are taking against corruption and money laundering. These cases provide significant assurance to states looking to recover stolen assets.

### Notes

1. [2001] 1 AC 102
2. [2015] UKPC 35. The case is available [here](#).
3. [1998] Ch 265 pp283-284
4. [2014] UKSC 45
5. [2015] UKPC 13

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