

### Backwards tracing

Angus O'Brien reports on *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599.

#### Introduction

'Tracing is the process of identifying a new asset as the substitute for the old.'<sup>1</sup> More particularly, where one asset is exchanged for another, tracing enables a trust beneficiary to treat the value in a substituted asset as representing the value in the original asset by making the substituted asset the subject of his claim.<sup>2</sup> Accordingly, tracing cannot avail a beneficiary where there is no value attributable to the original asset, such as where that value has been dissipated, e.g., by payment into an overdrawn bank account.<sup>3</sup> *Ex nihilo nihil fit*: nothing comes from nothing.

Two principles might be thought naturally to follow.

First, where misappropriated trust monies are deposited into a mixed bank account, the beneficiary's claim is limited to such an amount as does not exceed the lowest balance in the account during the period between the payment in of the trust money and the time when the disentanglement of the account falls to be made (the 'lowest intermediate balance rule').<sup>4</sup>

Secondly, trust money cannot be traced into an asset acquired before the money was misappropriated from the trust since the asset acquired does not represent the trust money (the 'principle against backward tracing').<sup>5</sup>

Despite their apparent orthodoxy, these principles – and particularly the principle against backward tracing – have been the subject of academic controversy<sup>6</sup> and conflicting authorities.<sup>7</sup> The decision of the Privy Council (on appeal from the Court of Appeal of Jersey) in *Durant* was the first time that they were authoritatively considered by a final appellate court in the Anglo-Australian common law world.

#### Facts and litigation history

In early 1998, Mr Paulo Maluf, then former mayor of the Municipality of Sao Paulo (the 'municipality'), received 15 payments which were bribes in connection with a major public road building contract. From 9 January to 6 February 1998, funds equivalent to 13 of those payments, amounting to \$10.5m, were converted to US dollars and paid into an account under the control of Mr Maluf's son (the 'Chanani Account'). From 14 to 23 January 1998, 6 payments totalling \$13.1m were made from the Chanani Account to an account held by a BVI-registered company ('Durant') controlled by Mr Maluf and/or his son (the 'Durant Account'). From 22 January to 23 February 1998, 4 payments totalling \$13.5m were made from the Durant Account to an account held by another BVI-registered company that was a wholly-owned subsidiary of Durant ('Kildare' and the 'Kildare Account').

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The municipality sought to trace the amount of \$10.5m to the Durant Account and thence to the Kildare Account. The defendants Durant and Kildare argued that their liability as constructive trustees was limited to \$7.7m for two reasons.

First, three of the payments into the Chanani Account were made after the final payment from the Chanani Account to the Durant Account. Accordingly, the principle against backwards tracing prevented those payments from being traced to the defendants.

Secondly, it was said that, by reason of the lowest intermediate balance rule, two payments from the Chanani Account to the Durant Account could not be said to have come from the bribes but must have come from other sources.

The defendants' arguments were unsuccessful in the Royal Court of Jersey and on appeal to the Court of Appeal. The defendants appealed again to the Privy Council.

#### Decision

Their Lordships recognised that '[c]onceptually the [defendants'] argument is coherent and it is supported by a good deal of authority.'<sup>8</sup> This authority included a majority of the English Court of Appeal in *Foskett v McKeown* [1998] Ch 265, albeit that the relevant observations were obiter.<sup>9</sup>

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However, their Lordships noted 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'.<sup>11</sup> In those circumstances, since equity is concerned with

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substance not form, it is permissible to look at the 'transaction overall'.<sup>12</sup> As a matter of policy, this was necessary given the sophistication of many modern frauds:

The development of increasingly sophisticated and elaborate methods of money laundering, often involving a web of credits and debts 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 a bank account of an intermediary before a reciprocal credit entry.<sup>13</sup>

Their Lordships accordingly rejected the defendants' submission that there could never be backwards tracing or tracing into an overdrawn bank account. However, for such tracing to occur, '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.' Their Lordships recognised that, '[t]his is likely to depend on inference from the proved facts, particularly since in many cases the testimony of the trustee, if available, will be of little value.'<sup>14</sup>

Since certain admissions in the pleadings meant that the necessary connection existed on the facts of *Durant*, the Privy Council dismissed the defendants' appeal.<sup>15</sup>

### Conclusion

*Durant* is a welcome decision for victims of fraud. English law's focus on substance rather than form ensures that it is well-equipped to enable victims of fraud to assert proprietary claims over substituted assets. However, the decision will be unwelcome for unsecured creditors of fraudsters. It has also

been said that the decision is disappointing for purists and that the need to assess whether the requisite connection between a series of transactions exists means each case will turn on its facts, with no general rules for guidance.<sup>16</sup>

Australian courts have not to date had cause to rule authoritatively upon the availability of backwards tracing.<sup>17</sup> It remains to be seen whether they will follow *Durant*.

### Endnotes

1. *Foskett v McKeown* [2001] 1 AC 102 at 127 per Lord Millett.
2. *Foskett v McKeown* [2001] 1 AC 102 at 128 per Lord Millett; Snell's Equity (33<sup>rd</sup> ed., 2015) at 786 [30–051].
3. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [17]; *Lewin on Trusts* (19<sup>th</sup> ed., 2014) at 2030 [41–109].
4. *Lewin on Trusts* (19<sup>th</sup> ed., 2014) at 2008 [41–070].
5. *Lewin on Trusts* (19<sup>th</sup> ed., 2014) at 2031 [41–112].
6. See especially Smith, 'Tracing into the Payment of a Debt' (1995) 54 CLJ 290 and *The Law of Tracing* (1997) at 146–152 and 215–217 (in defence of backward tracing); Conaglen, 'Difficulties with tracing backwards', (2011) 127 LQR 432 (against backward tracing).
7. See especially *Bishopsgate Investment Management Ltd v Homan* [1995] Ch 211 (CA) at 216–217 per Dillon LJ, at 221 per Leggatt LJ and at 222 per Henry LJ; *Foskett v McKeown* [1998] Ch 265 (CA) at 283–284 per Scott V-C; *Shalson v Russo* [2005] Ch 281 at [141] per Rimer J.
8. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [18].
9. See *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [24]–[26].
10. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [33].
11. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [34].
12. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [37].
13. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [38].
14. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [40].
15. *The Federal Republic of Brazil v Durant International Corporation* [2015] UKPC 35; [2015] 3 WLR 599 at [42].
16. See STEP, 'UK Privy Council allows backward tracing of bribes paid to former Brazilian mayor', 6 August 2015, quoting Craig Connal QC of Pinsent Masons.
17. See *Grimaldi v Chameleon Mining NL (No. 2)* (2012) 200 FCR 296 at 447 [707]; *Georges v Seaborn International Pty Ltd* (2012) 206 FCR 408 at 440–442 [179]–[192]; *Conlan (as liquidator of Rowena Nominees Pty Ltd) v Connolly (as trustee for Connolly Family Trust)* [2011] WASC 160 at [52]–[96]; *Re Rowena Nominees Pty Ltd; Ex parte Conlan* [2006] WASC 69 at [64]–[67].