Tracing backwards and through overdrawn accounts

By Dov Ohrenstein

Anyone involved in cases concerning the tracing of assets will be interested in **Durant v Brazil** [2015] UKPC 35, a recent decision of the Privy Council.

The Government of Brazil had succeeded at the trial in Jersey of a tracing claim for the repayment of alleged bribes paid to the former mayor of Sao Paolo. The bribes had initially been paid into a New York bank account from which transfers were made to Jersey bank accounts.

On appeal to the Privy Council two arguments were pursued by the defendants, both of which could find plenty of support in previous case law.

Firstly, the defendants relied on the *"lowest intermediate balance rule",* which is based on the reasoning that if something has ceased to exist it cannot be transformed into a later property interest so that if the balance in a bank account has dwindled to zero or into overdraft then even if the account is subsequently replenished and in credit there can be no tracing of funds in the account.

Secondly, the defendants argued that *"the backwards tracing rule"* meant that no tracing of certain money from New York to Jersey could occur because the relevant payments had only been paid into the New York account after the last of the relevant payments out from that account to Jersey. The rationale for the rule is that a property interest cannot turn into (or provide a substitute for) something which the holder already has since the later acquisition cannot be the source of the earlier.

The Privy Council rejected both the argument that the court can never trace the value of an asset whose proceeds are paid into an overdrawn account and the argument that there can never be backward tracing. However, it held that a successful 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, particularly since in many cases the testimony of the trustee, if available, will be of little value.

© Dov Ohrenstein
dov@radcliffechambers.com

The public policy reasons behind the Privy Council's decision are clear from what Lord Toulson stated in the judgment:

"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 [...] a debit appears in the bank account of an intermediary before a reciprocal credit entry."

The Privy Council's **Brazil** decision is likely to be followed by the English Courts and has provided welcome clarification as previously there had been considerable disagreement between judges as to the relevant legal principles to apply on backwards tracing and tracing via depleted accounts.

For example, at first instance in **Bishopsgate Investment Management Ltd (In Liquidation) v Homan** [1995] Ch 211 Vinelott J said that *"proof that [money was] paid into overdrawn account … may not always be sufficient to bar a claim to an equitable charge".* However, although on appeal Dillon LJ considered that it was at least arguable that this analysis was correct, Leggatt LJ did not accept that it was possible to trace through an overdrawn account, or to trace misappropriated money into an asset bought before the money was received by the purchaser. Henry LJ unhelpfully stated that he agreed with both his fellow judges on the appeal panel!

There were similar disagreements between the members of the Court of Appeal in **Foskett v McKeown** [1998] Ch 265 where the majority held (with Scott VC dissenting) that the doctrine of tracing does not extend to following value into a previously acquired asset. The point did not have to be determined when **Foskett** went to the House of Lords. Nevertheless, Scott VC's analysis has been now vindicated by the Privy Council in **Brazil**:

*"The Board agrees with Sir Richard Scott V-C's observation in **Foskett v McKeown** 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 occur."*

The Privy Council's decision means that fraudsters and other persons acting in breach of fiduciary duty will now not be able to ring fence their assets from tracing claims by simple devices such as

Radcliffe Chambers
11 New Square, Lincoln's Inn
London WC2A 3QB
clerks@radcliffechambers.com

T: 020 7831 0081
F: 020 7405 2560
DX: 319 London
www.radcliffechambers.com

by passing the payments through overdrawn accounts or by purchasing those assets with loans repaid by trust monies. This is good news for beneficiaries trying to recover trust assets but not for wrongdoers and unsecured creditors seeking to defeat tracing claims.

Dov Ohrenstein
Radcliffe Chambers
dov@radcliffechambers.com