[2015] UKPC 35

Privy Council Appeal No 0069 of 2013

JUDGMENT

The Federal Republic of Brazil and another (Respondents) v Durant International Corporation and another (Appellants) (Jersey)

From the Court of Appeal of Jersey

before

Lord Neuberger

Lord Mance

Lord Carnwath

Lord Toulson

Lord Hodge

JUDGMENT GIVEN ON

3 August 2015

Heard on 7 May 2015

Appellants	Respondents
David Lord QC	Charles Dougherty QC
Paul Nicholls	Emma Jordan
(Instructed by Blake Morgan LLP)	(Instructed by Wragge Lawrence Graham & Co LLP)

LORD TOULSON:

1.
This appeal concerns the doctrine of tracing. The effective plaintiff is the Municipality of Sao Paulo ("the municipality"). The Federal Republic of Brazil is nominally a plaintiff because its Constitution requires it to be a party to any action brought outside Brazil by a Brazilian public authority. The defendants ("Durant" and "Kildare") are companies registered in the British Virgin Islands. Kildare is a wholly owned subsidiary of Durant and both companies are or were at the relevant time under the practical control of Mr Paulo Maluf and/or his son Mr Flavio Maluf. From 1993 to 1996 Mr Maluf senior was mayor of the municipality.

2.
Durant and Kildare appeal to the Board against a decision of the Court of Appeal of Jersey, which upheld a judgment of the Royal Court that the companies were liable to the municipality as

constructive trustees of US$10,500,055.35 representing bribes to Mr Maluf senior in connection with a major public road building contract. The findings of fact by the Royal Court are no longer challenged, but the appellants contend that the total amount which can be properly traced to them from the bribes is limited to US$7,708,699.10.

3.
The judge found that in early 1998 Mr Maluf senior, or others on his behalf, received 15 secret payments, and that funds equivalent to 13 of those payments were converted to US dollars and paid into an account under the control of Mr Maluf junior with the Safra International Bank of New York in the name of Chanani ("the Chanani account").

4.
The 13 payments were itemised in a schedule (schedule 3) to the Order of Justice (or statement of claim) issued by the municipality in the Royal Court. They spanned a period from 9 January to 6 February 1998 and amounted in all to US$10,500,55.35. In their Amended Answer the companies asserted that the payments itemised in schedule 3 had nothing to do with Mr Maluf senior's position as a holder of political office, but represented legitimate brokerage commissions earned by him in connection with an agreement for the acquisition of a company, for introducing the parties, who were both well known to him, and assisting in their negotiations. This defence was rejected.

5.
Over the period of ten days from 14 to 23 January 1998 there were six payments from the Chanani account to an account held by Durant with Deutsche Bank in Jersey ("the Durant account"). These payments were itemised in schedule 4 to the Order of Justice. They totalled US$13,120,000.00.

6.
Over the period from 22 January to 23 February 1998 there were four payments from the Durant account to an account held by Kildare also with Deutsche Bank in Jersey ("the Kildare account"). These payments were itemised in schedule 5 to the Order of Justice. They totalled US$13,500,000.00.

7.
The municipality claimed to trace the amount of the schedule 3 payments (US$10,500,055.35) to the Durant account and thence to the Kildare account. It asserted that the full amount of those bribes was paid from the Chanani account to the Durant account. It did not make any claim in respect of the excess of the amount paid from the Chanani account to the Durant account (or from the Durant account to the Kildare account) over the amount of the schedule 3 payments.

8.
The companies' pleaded response to the municipality's allegation, in paragraph 21 of the Order of Justice, that the bribes itemised in schedule 3 were paid from the Chanani account to the Durant account was in the following terms:

"As to paragraph 21 of the Order of Justice, it is admitted that the commissions referred to in paragraph 20 hereinbefore [the schedule 3 payments] were paid from the Chanani account to the bank account of Durant held with Deutsche Morgan Grenfell (CI) Limited as particularised in schedule 4 of the Order of Justice. Specifically, it is denied that the said sums so particularised ... amount to bribes and/or secret commissions relating to, and/or the proceeds of, the alleged or any fraud."

9.

The appellants' case that their liability as constructive trustees is in round figures for US$7.7m, and not for US$10.5m, has two limbs.

10.
One is that the last three payments into the Chanani account identified as proceeds of bribery were made on dates between 26 January and 6 February 1998, and so came after the final payment from the Chanani account to the Durant account. It is submitted that those three payments into the Chanani account cannot be traced to the appellants because there is no sound doctrinal basis for "backwards tracing".

11.
The other limb of the appellants' argument is that the Chanani account was a mixed account; and that where a claimant's money is mixed with other money, and drawings are made on the account which reduce the balance at any time to less than the amount which can be said to represent the claimant's money, the amount which the claimant can thereafter recover is limited to the maximum that can be regarded as representing his money ("the lowest intermediate balance rule"). In this case it is said that on two occasions (20 and 23 January 1998) payments were made from the Chanani account to the Durant account of sums which exceeded the maximum that could be said to have come from the earlier bribes itemised in schedule 3 and must therefore have come from other sources.

12.
The parties agreed at the trial, as a matter of arithmetic, that if either limb of the argument was correct, the effect would be to limit the traceable amount to the same figure of US$7.7m.

13.
The Royal Court (HWB Page QC, Commissioner and Jurats Kerley and Marett-Crosby) rejected the appellants' arguments. After a thoughtful and thorough review of the authorities and academic writings, the court concluded that the law was uncertain, that at a conceptual level the subject seemed incapable of wholly satisfactory solution and that at the level of policy it was unlikely to be settled in English Law below the Supreme Court. Its own view was that Jersey law should not set its face against accepting that "backward tracing" may be legitimate. It said that, at least where the account remained in credit during the relevant period, so there was no question of possible insolvency and prejudice to unsecured creditors, and where there was no suggestion of an intervening bona fide purchaser for value, the question should be whether there was sufficient evidence to establish a clear link between credits and debits to an account. If such a link were established, the court did not consider that there was cause to diminish its effect by introducing the concept of "a lowest intermediate balance rule". It considered that, as a matter of judicial policy, this approach would accord most closely with considerations of justice and practicality. It observed that otherwise any sophisticated fraudster would be able to defeat an otherwise effective tracing claim simply by manipulating the sequence in which credits and debits were made to his account.

14.
The judgment continued:

"Take, for example, a situation in which a debit on one day and a credit a few days later are each accompanied by a bank notification advice unequivocally indicating that they relate to one and the same transaction. Is it to be said in such circumstances that the later credit cannot be traced into the earlier debit simply because of the order in which the two items appear on the bank statement or because at some point between the two the balance on the account fell, say, to zero before being

replenished with new funds? As Professor Andrew Burrows observes in his treatise on The Law of Restitution, 3rd ed (2011), p 142:

‘Indeed it would seem that ‘backward tracing’ must be accepted if one is to explain tracing into and through ‘in credit’ bank accounts. This is because if one is tracing funds into a bank account, the account is often credited before the bank has received the relevant funds. In other words, the debt owed by the bank to the customer, which is treated as a substitute for the funds, exists in advance of the funds being received.’”

15.
On the question whether there was the necessary link, the court observed that it was the appellants’ own pleaded case that the relevant payments into the Durant account were linked with one another, allegedly as commission earned in a particular transaction, as well as with the payments into the Chanani account, and it concluded that the link between the payments listed in schedule 3 and schedule 4 could not be plainer.

16.
The Court of Appeal (James McNeill, QC, President, Jonathan Crow, QC and Sir David Calvert-Smith) upheld the reasoning and conclusions of the Royal Court.

17.
The appellants’ twin arguments have a common and simple logical parentage. The doctrine of tracing involves rules by which to determine whether one form of property interest is properly to be regarded as substituted for another. It is therefore necessary to begin with the original property interest and study what has become of it. If it has ceased to exist, it cannot metamorphose into a later property interest. Ex nihilo nihil fit: nothing comes from nothing. If the money in a bank account has dwindled from £1,000 to £1, only the remaining £1 is capable of being substituted by something else; the £999 has ceased to exist. This explains “the lowest intermediate balance” principle. Similarly, a property interest cannot turn into (or provide a substitute for) something which the holder already has; the later acquisition cannot be the source of the earlier. This explains the “no backward tracing” principle. The two are in a sense opposite sides of the same coin.

18.
Conceptually the appellants’ argument is coherent and it is supported by a good deal of authority.

19.
In James Roscoe (Bolton) Ltd v Winder [1915] 1 Ch 62 a company sold its business under an agreement containing a promise by the purchaser to collect on behalf of the vendor the amount of the book debts owed to it at the date of the agreement. From the sums collected, the purchaser paid £455 into his general bank account, but he failed to account for the money to the vendor and made drawings from the account which reduced it at one stage to £25. He later made payments into the account from an unrelated source, and died with a balance in his account of £358, to which the vendor claimed to be beneficially entitled. Sargant J held that the maximum which the vendor was entitled to trace was £25, representing the lowest sum to which the balance on the account had fallen between the payment of the £455 into the account and the purchaser’s death, on the ground that at that date of the lowest balance the purchaser must have denuded the account of all the trust moneys except to the extent of £25.

20.

In In re Goldcorp Exchange Ltd [1995] 1 AC 74 a company mixed bullion belonging to some of its customers with other bullion. It then reduced its stock to less than the amount which belonged to those customers. It later bought more bullion, but there was no evidence to link the later purchases with the earlier depletion of the stock. On the company being placed in receivership, the customers claimed an equitable lien over the stock of bullion held by the company at the time of the receivers' appointment. The judge found that the amount of bullion held by the receivers on behalf of those customers was an amount equal to the lowest balance of bullion held by the company at any time, applying James Roscoe (Bolton) Ltd v Winder. The Board upheld his decision. Lord Mustill, at p 109, cited the judgment of the Court of Appeal in In re Diplock [1948] Ch 465, 521, where it was said:

"The equitable remedies presuppose the continued existence of the money either as a separate fund or as part of a mixed fund or as latent in property acquired by means of such a fund. … It is, therefore, a necessary matter for consideration in each case where it is sought to trace money in equity, whether it has such a continued existence, actual or notional, as will enable equity to grant specific relief."

Lord Mustill observed that the law relating to equitable tracing was still in a state of development, but that it would be inequitable to impose an equitable lien in favour of the customers in that case, since there was no evidence that their bullion continued to exist as a fund latent in property held by the company.

21.
In Bishopsgate Investment Management Ltd (In Liquidation) v Homan [1995] Ch 211 large amounts of funds held by Bishopsgate on trust under various pension schemes were improperly paid into a bank account of Maxwell Communication Corporation plc ("Maxwell CC"). The account was either overdrawn at the time of the payments or subsequently became overdrawn. Maxwell CC was hopelessly insolvent and was subsequently placed in Chapter XI protection under the US Bankruptcy Code. The administrators wished to make an interim distribution to Maxwell CC's creditors, but Bishopsgate's liquidators claimed to be entitled to an equitable charge over the whole of the moneys in the account, which happened to be in credit at the time of the administrators' appointment.

22.
At first instance Vinelott J held that Bishopsgate could not trace through an overdrawn bank account, whether it was overdrawn at the time when the relevant moneys were paid into it or became overdrawn by subsequent drawings, subject to a reservation if it were shown that there was a connection between a particular misappropriation and the acquisition by Maxwell CC of a particular asset. He considered that there could be backward tracing if, for example, an asset was acquired by Maxwell CC with moneys borrowed from an overdrawn account and there was an inference that when the borrowing occurred it was the intention that it should be repaid by misappropriation of Bishopsgate's moneys. His conclusion was that "proof that [money was] paid into an overdrawn account … may not always be sufficient to bar a claim to an equitable charge".

23.
Bishopsgate's liquidators appealed, and Maxwell CC's administrators served a respondent's notice by way of cross-appeal, asking the Court of Appeal to overrule the judge's reservations. Dillon LJ considered it to be at least arguable that if the connection postulated by the judge were proved, there ought to be an equitable charge in favour of Bishopsgate over the particular asset, and he held that both the appeal and the cross-appeal should be dismissed. By contrast, Leggatt LJ held that there could be no tracing remedy against an asset acquired before misappropriation of money took place, since the money could not be traced into something which had been acquired before the money was

received and therefore without its aid; but he accepted that if an asset were used as security for an overdraft, which was then discharged by means of misappropriated money, the beneficiary might obtain priority by subrogation. He therefore considered that the judge came to the right conclusion, although he 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. The third member of the court, Henry LJ, stated laconically that he agreed with both judgments.

24.
The Court of Appeal was again divided in Foskett v McKeown [1998] Ch 265. The claim was by purchasers who advanced money on trust under a property development scheme which was never carried out. The issue was whether they could trace their money into the proceeds of a life insurance policy. The matter came before the court on an application for summary judgment, before the facts had been fully investigated. In his judgment Sir Richard Scott V-C said at pp 283-284:

“I regard it as likely, that [the purchasers] will establish that it was [the deceased’s] intention throughout to use [the] purchasers’ money to pay the 1988 premium. If that is the case, it does not seem to me at all obvious that the circumstance that the payment into the account of the purchasers’ money was made very shortly after the payment of the premium, rather than before or at the same time as the payment, should be regarded as fatal to the purchasers’ equitable tracing claim. 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. Moreover, there is at least some authority which the purchasers could pray in aid: see Agricultural Credit Corpn of Saskatchewan v Pettyjohn (1991) 79 DLR (4th) 22 and [Professor Lionel Smith] “Tracing into the Payment of a Debt” [1995] CLJ 290, 292-295.”

25.
The majority of the court took a different view. Hobhouse LJ and Morritt LJ both held that the doctrine of tracing does not extend to following value into a previously acquired asset. Morritt LJ said at p 296 that the claimants “must be able to identify the money of the purchasers at every stage of the process: In re Diplock [1948] Ch 465, 521”.

26.
The point in question did not require to be decided and so these observations were obiter. It was not discussed when the case reached the House of Lords, but there is a relevant passage in the speech of Lord Millett at [2001] 1 AC 102, 127-128:

“We speak of money at the bank, and of money passing into and out of a bank account. But of course the account holder has no money at the bank. Money paid into a bank account belongs legally and beneficially to the bank and not to the account holder. The bank gives value for it, and it is accordingly not usually possible to make the money itself the subject of an adverse claim. Instead a claimant normally sues the account holder rather than the bank and lays claim to the proceeds of the money in his hands. These consist of the debt or part of the debt due to him from the bank. We speak of tracing money into and out of the account, but there is no money in the account. There is merely a single debt of an amount equal to the final balance standing to the credit of the account holder. No money passes from paying bank to receiving bank or through the clearing system (where the money flows may be in the opposite direction). There is simply a series of debits and credits which are causally and transactionally linked. We also speak of tracing one asset into another, but this too is inaccurate. The original asset still exists in the hands of the new owner, or it may have become untraceable. The

claimant claims the new asset because it was acquired in whole or in part with the original asset. What he traces, therefore, is not the physical asset itself but the value inherent in it."

27.
When Lord Millett speaks of "money paid into a bank account" (which then "belongs legally and beneficially to the bank"), generally what happens, in law, is the extinction of one credit/debit and creation of another credit/debit through the banking system, although a bank may sometimes receive payment of money in specie. So if a customer "pays" a cheque into his account, his bank will present the cheque to the bank on which it is drawn ("the paying bank"), and – provided that the drawer has a credit balance with the paying bank, or a borrowing facility sufficient to cover the amount of the cheque – the paying bank will credit the presenting bank with the amount of the cheque through the banking system, and will debit its customer's account. The presenting bank may already have credited its own customer's account, in anticipation of the cheque being cleared, in which case a legal purist would say that the statement of account is for the moment inaccurate, and it will be corrected by a corresponding debit entry if the cheque is dishonoured (or should turn out to be a forgery).

28.
The appellants' argument has academic support, most fully developed in Professor Matthew Conaglen's article "Difficulties with tracing backwards" (2011) 127 LQR 432, written in riposte to the argument of Professor Smith (to which Sir Richard Scott V-C referred in Foskett v McKeown).

29.
Professor Conaglen begins with the proposition that "Tracing is the process of identifying a new asset as the substitute for the old" (per Lord Millett in Foskett v McKeown at [2001] 1 AC 102, 127). He observes that the acquisition of an asset and the extinguishment of a debt are different things. A debt is an asset in the hands of the creditor, and so can provide a basis for traditional tracing in relation to the creditor's assets. But a debt has no asset value in the hands of the debtor; it is a liability which ceases to exist when it is paid.

30.
Having said that, Professor Conaglen accepts that there is nothing conceptually impossible about the courts tracing trust funds through the payment of a debt into assets that the trustee had acquired, before that payment was made, by incurring the debt. But he argues that the support in the case law for such an approach is weak and that there is stronger authority against it.

31.
Professor Conaglen recognises that it is ultimately a matter of legal policy whether the law ought to allow backward tracing. He concludes, at p 455:

"When the already precarious position of unsecured creditors is weighed against the concomitantly far better protected position of trust beneficiaries, it is suggested that the law ought not to recognise the possibility of tracing backwards. The unsecured creditors should not have their position worsened further by effectively making them insurers for the beneficiaries against trustee defalcations. Trust beneficiaries whose money has been wrongly applied in satisfaction of a debt can stand in the position of the satisfied creditor (by subrogation), but it is a step too far, in policy terms, to allow them to stand in the position of the debtor and act as owners of property that the trustee acquired before the debt was paid.

Alternatively, if backward tracing is to be allowed, then the policy concerns that have been highlighted above suggest that the extent to which payment of the debt is considered attributable to

acquisition of the asset should perhaps be limited in some way, such as by reference to whether the trustee intended at the time the asset was acquired to (mis)use trust funds to pay for it. … That would be consistent with equity's traditional concern for substance – meaning intention – over form. However, the evidential difficulties inherent in a test that is focused on the defalcating trustee's intentions provide yet further reasoning for concluding that the balance is appropriately struck by refusing to recognise backward tracing."

32.
The respondents found their arguments on the passage already quoted from in Lord Millett's speech in Foskett v McKeown. They emphasise that it is inaccurate to speak of tracing one asset into another. Rather, the court is concerned with tracing the value inherent in a trust asset. Whether it can properly be traced into another asset depends on whether there is a sufficient transactional link. In considering that question the court should concentrate on the substance of the transaction and not the form. In general terms those propositions carry force, but they do not resolve the disputed issues.

33.
More particularly the respondents submit, as Professor Smith argues, that money used to pay a debt can in principle be traced into whatever was acquired in return for the debt. That is a very broad proposition and it would take the doctrine of tracing far beyond its limits in the case law to date. As a statement of general application, the Board would reject it. 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.

34.
However 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. Agricultural Credit Corpn of Saskatchewan v Pettyjohn (1991) 79 DLR (4th) 22 (Sask CA) provides a good example. In 1981 and 1984 Mr and Mrs Pettyjohn applied to the credit corporation for loans to purchase cattle. They were informed that their applications were approved and that they could proceed to make the purchases. The Pettyjohns went ahead and bought cattle using a credit line with their bank as their immediate source of funding. About the same time, or shortly afterwards, the loan agreements with the credit corporation were executed, under which the credit corporation was given security over the cattle, and the moneys advanced by the credit corporation were used to pay back the bank. Sometime later the Pettyjohns sold the cattle (without the credit corporation's agreement), bought replacement cattle and used the proceeds of sale to repay the loan for the purchase of the replacement cattle. They then became insolvent.

35.
The credit corporation claimed to have a purchase money security interest in the replacement cattle under the Personal Property Security Act. The claim gave rise to two issues: whether the lender had a right to security over cattle which were purchased after the loan application had been approved but before the loan moneys had been advanced: and, if so, whether the lender was entitled to trace the value of its original security into the replacement cattle.

36.

The Saskatchewan Court of Appeal decided the case in favour of the credit corporation. Its decision on the second point turned on the construction of the provisions of the Act, but its decision on the first point is of general interest. Under the Act it was necessary for the credit corporation to establish that it gave value to the debtor for the purpose of enabling the debtor to acquire rights in personal property (as it undoubtedly did) and, more importantly, that the value was applied to acquire the rights. On that issue the court said at p 38:

"The … requirement, that the value have been used to acquire such rights, presents greater difficulties. How can it be said that the moneys advanced were used to acquire rights when the purchase had already taken place and the rights already acquired? It is, however, commercially unreasonable to divide the transactions so minutely. The Pettyjohns used the value given to them to pay off interim financing, but the interim financing had not been obtained as a separate transaction, but always with the view that it would be repaid through the moneys advanced by ACCS. The Pettyjohns used the value given as part of a larger, commercially reasonable transaction to acquire rights in the 1981 and 1984 cattle. The fact that the use of the value given was, due to the nature of the transaction, after the acquisition of rights does not alter the conclusion that the value given was used to acquire those rights."

37.
On those facts the court was right in the view of the Board not to divide minutely the connected steps by which, on any sensible commercial view, the purchase of the cattle was financed by the credit corporation, but to look at the transaction overall. The interposition of the bank was purely to provide bridging finance to cover the gap in time between the purchase and the credit corporation's funds coming through as previously arranged.

38.
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. 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.

39.
Similarly, in a case such as Agricultural Credit Corpn of Saskatchewan v Pettyjohn, the Board does not consider that it should matter whether the account used for the purpose of providing bridging finance was in credit or in overdraft at the time. An account may be used as a conduit for the transfer of funds, whether the account holder is operating the account in credit or within an overdraft facility.

40.
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, particularly since in many cases the testimony of the trustee, if available, will be of little value.

41.
The Board does not doubt the correctness of the decisions in James Roscoe (Bolton) Ltd v Winder and In re Goldcorp Exchange Ltd, but in neither case was there evidence of an overall transaction embracing the coordinated outward and inward movement of assets.

42.
In the present case the Royal Court and the Court of Appeal were justified in concluding that the necessary connection between the bribes itemised in schedule 3 and the receipts itemised in schedule 5 was proved, having regard in particular to the admission in the pleadings as to the link between the sums received by the appellants and the Chanani account. The Board will therefore humbly advise Her Majesty that the appeal should be dismissed.