

Tracing a new path - The final word – The Federal Republic of Brazil and Anor v Durant

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The Judicial Committee of the Privy Council has handed down a landmark judgment concerning the doctrine of tracing, which confirms the approach taken by the Jersey Court of Appeal and the Royal Court of Jersey to the previously unsettled question of whether "backwards tracing", as it has been called, is permissible in Jersey law.

Facts

The Federal Republic of Brazil and The Municipality of Sao Paolo (the Plaintiffs) claimed against approximately USD 10.5 million that had been paid into bank accounts of the Defendants in Jersey (the Funds). The Funds were alleged to have been the traceable proceeds of bribes received by the former Mayor of Sao Paolo, Paulo Maluf, and his son Flavio (together the Malufs) during Paulo's time in office.

The Plaintiffs claimed that the Funds had made their way to Jersey via unidentified black-market currency dealers (Doleiros) in Brazil and an account beneficially owned and controlled by the Malufs in New York (the New York Account). The claim was not one for damages, but rather for the recovery of the Funds on the grounds that the Defendants were constructive trustees of the Funds held by them with knowledge of their tainted origin; alternatively on grounds of unjust enrichment or a proprietary claim to the Funds.

The issues

The first issue was that the last three payments into the New York Account identified as the proceeds of bribery were made on dates which came after the final payment from the New York

Account into the Jersey accounts. It was submitted that those three payments could not be traced, as to do so would be tracing “backwards”, for which there was no sound doctrinal basis.

The second issue was that the New York Account had been a mixed account; and that where a Plaintiff’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 Plaintiff’s money, the amount that the Plaintiff can thereafter recover is limited to the maximum that can be regarded as representing his money (known as the “lowest intermediate balance rule”).

Decision

The Privy Council looked to the substance of the transactions in question, rather than the strict order in which associated events occurred, and held that the payments in question could be traced. Lord Toulson, delivering the Judgment, stated:

“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 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.”

In doing so, the Privy Council rejected the argument that there can never be “backwards” tracing, or that the court can never trace the value of asset whose proceeds are paid into an overdrawn account. Rather, it stated that a 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.

Comment

The approach of the Privy Council is consistent with equity’s traditional concern for substance over form, and allows the court the flexibility, when presented with clear evidence of a coordinated scheme to misuse trust funds, to look through that scheme.

However, the wider implications of such an approach remain to be seen. In particular, it is not clear what will happen where there are questions of insolvency, prejudice to unsecured creditors, the involvement of third parties acquiring assets for value or multiple victims of fraud. Moreover, it will be interesting to see how the Courts in future deal with the evidential difficulties inherent in a test that is essentially focussed on the alleged money launderer’s intentions.

For those holding assets for others whether as banker, trustee, custodian or fund manager, this judgment underlines the importance of understanding the ultimate source of funds received. Without such an understanding any financial institution is at risk of finding itself drawn into complex legal and regulatory claims including claims for paying away assets that might be found to belong to third parties.

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