Navigating the freeze - a Guernsey bank's stance on a payment instruction

Insights - 15/08/2024

There has been a run of court cases since 2009 in which a beneficiary of funds held by a Guernsey-based custodian has had to bring a civil claim against said custodian to prove those funds are not the proceeds of crime or derived from criminal conduct.

The latest is *Jakob International Inc v HSBC Private Bank (Suisse) SA, Guernsey Branch [2024] GRC*. Ogier has acted for HSBC since proceedings began in 2015 (and then discontinued on terms in 2018. They were re-commenced in 2021, culminating in a week-long trial in October 2023). Ogier has also has participated in similar cases, acting for custodian or beneficiary. One week-long trial in April 2024 which Ogier was also involved in resulted in the Royal Court of Guernsey concluding that funds held by the custodian were not the proceeds of crime and could be released (*Loero v Credit Suisse Trust Limited (2024)*, decision given at the conclusion of the trial with written judgment awaited). Ogier is currently acting for an investment manager and administrator of funds held in Guernsey in ongoing proceedings brought by a beneficiary.

Such disputes can cause significant disruptions. They can lead to financial losses, legal complications and reputational damage for all involved.

Why does a beneficiary have to prove this, and what do the parties have to prove when the case gets to trial? We explore both sides in this article. The terms "custodian" and "beneficiary" are used because, while most of the authorities relate to a banking relationship between a bank and its customer (such as the *Jakob* case itself), some stem from a trustee / beneficiary relationship. Therefore it is more appropriate to label the entity holding the funds as the custodian, and the entity or person entitled to the funds as the beneficiary rather than customer.

The legal framework in Guernsey for proceeds of crime cases

Section 38(3) of the Criminal Justice (Proceeds of Crime) (Bailiwick of Guernsey) Law, 1999 and

sections 1 and 2 of the Disclosure (Bailiwick of Guernsey) Law, 2007 require a person who suspects that funds or investments are derived from or used in connection with criminal conduct to file a Suspicious Activity Report to the Guernsey Financial Intelligence Unit (**FIU**). Once the report is made, the person cannot deal with or dissipate the funds or investments without the FIU's consent. If none is forthcoming, the funds or investments are frozen.

Anti-money laundering (**AML**) legislation prevents the custodian telling the beneficiary about the Suspicious Activity Report. This often leads to frustration on both sides. The beneficiary does not understand why the custodian is unable to pay. The custodian cannot do anything with the funds due its obligation to file a report with the FIU, but cannot tell its client why.

In the United Kingdom, the UK FIU has 31 days to decide what to do with the potentially tainted funds. It can apply to the UK courts for a civil forfeiture or confiscation order within that period. If it doesn't, the custodian is free to honour its customer's instructions. In comparison, Guernsey has an open-ended discretion on the FIU, and no time limit. So if the FIU does nothing, the funds sit with the custodian, which is unable to do anything about it for fear of committing an offence.

The Guernsey Court of Appeal justified this in *Chief Officer of Customs & Excise, Immigration and Nationality Service v Garnet Investments Limited [2011-12 GLR 250]* on the basis that Guernsey is less resourced than the UK and because many funds flowing through Guernsey emanate from around the world, the FIU must liaise with multiple foreign regulatory authorities in its investigations. This takes time and makes an equivalent to the UK 31-day period inappropriate.

However, with the introduction of the Forfeiture of Assets in Civil Proceedings (Bailiwick of Guernsey) Law, 2023, it may justify a new time period (longer than 31 days) for the FIU to take action. For now, we have still an open-ended period. Therefore, funds involved in a Suspicious Activity Report are, in effect, frozen in the hands of the custodian if the FIU does not provide consent.

What can a beneficiary do to obtain their funds in Guernsey proceeds of crime cases?

The *Garnet* decision demonstrated two ways a beneficiary can take action:

1: Bring a judicial review action against the FIU. Procedurally, this is hard to initiate, must be prompt and can be expensive. They only review the decision itself and may not actually reverse it if the court finds that any reasonable law enforcement agency would reach the same conclusion and it is not irrational or unlawful. So it's probably not advisable except in the most extreme circumstances.

2: Bring a "private law action" against the custodian. Here, the beneficiary sues the custodian for breach of mandate or contract for refusing to honour the payment instruction. Here, any tipping-

off offence falls away because contentious proceedings are afoot. The custodian can therefore plead that it filed a Suspicious Activity Report and did not receive consent from the FIU, so is unable to honour the instruction. This provides a complete defence to the claim, assuming its terms and conditions state that the custodian would not honour an instruction if the custodian would then commit a criminal offence. At this point, the case is no longer a "normal" civil action but a case of two principal issues:

- Is the custodian justified in making the Suspicious Activity Report? Are its suspicions reasonable?
- Can the beneficiary prove the funds are from a clean source?

This was identified in the earlier decision in Jakob International Inc v HSBC Private Bank (CI) Limited from 2016 (an application by the bank to strike out the claim). It has been applied by the Court in all decisions since.

Reasonable suspicion that funds are the proceeds of crime?

The first element looks at the custodian's state of mind when making the Suspicious Activity Report. If a suspicion is formed, the custodian must make the report under the legislative framework. The test comes from an English decision in *R v Da Silva [2007] 2 WLR 303* that the custodian "must think there is a possibility, which is more than fanciful, that the relevant facts exist. A vague feeling of unease would not suffice". While the burden is on the custodian to show that its suspicions were correct, it is a low hurdle to overcome. In all cases in Guernsey so far, the beneficiary plaintiff has accepted in advance that the suspicion was reasonably formed. Therefore, the *Da Silva* test has never been required.

The advantage to a plaintiff accepting the custodian's suspicion was reasonable is that the trial can focus on provenance only. This makes it more likely that the custodian will adopt a neutral position. Most financial institutions in Guernsey adopt sophisticated and ongoing measures to review their clients. Most of these come from public sources. A beneficiary's involvement, or suspicions that those behind the beneficiary have involvement, in criminal activity can trigger suspicion within the custodian. It is easy to understand why a financial institution would err on the side of caution by forming a suspicion based on adverse media reports.

The custodian will not have direct knowledge of whether the funds are derived in some way from criminal conduct. That is for the beneficiary to prove. The custodian only needs to show it reasonably suspects that the funds it is holding might be derived from criminal activity because the beneficiary, or those standing behind it, have previously been linked to it.

At this point, the custodian is not neutral. Its very internal workings are being attacked by the

beneficiary, which is accusing it of forming suspicions without meaningful basis. It is going to be hard to show that a regulated and professional organisation has not formed a suspicion without reasonable basis. This is why most beneficiaries are advised not challenge this.

Proving the funds are not the proceeds of crime

Once a suspicion is determined, either by consent or the court, the case then looks at the origin of the funds. The beneficiary must prove this on the balance of probabilities. This involves, among other things, a forensic accounting exercise looking as far back as possible to prove that the funds derive from legitimate sources. This process was described by the court in *LMNB v Credit Suisse AG (Guernsey Branch) [2023] GRC 026* as using sufficiently clear and credible evidence to prove a negative, but achievable by proving the actual source of the funds was innocent and untainted. This does not involve a formal tracing exercise, but rather shows a common-sense impression, on the balance of probabilities, that the funds are clean.

In *Jakob*, the plaintiff used two evidential methods:

- Witness testimony, using existing documents, to show the original source of the funds.
- Expert evidence to show the flow of funds into the account held by the bank in question.

This was successful with the plaintiff able to show, on the balance of probabilities, that the funds did not derive from the criminal activity of the beneficial owner's husband. A similar exercise was deployed in *Liang v RBC Trustees (Guernsey) Ltd [2018] GLR 189*, a case in which Ogier was also involved for the beneficiary until just before trial.

At his point, the custodian's role is neutral as it has fulfilled its role in reporting its suspicion. Once the custodian has determined the accuracy of that suspicion, it should have no interest in the release of the monies.

However, the custodian's advocate will need to cross-examine the plaintiff's witnesses from a neutral standpoint. This role has developed through the run of cases. The author's role at the trial of the *Jakob* case was to probe the evidence to assist the court, as a sort of friend of the court. The custodian's role could even extend to suggesting alternative case theories as part of that cross-examination and submissions, but it should not go so far as making a positive alternative case, given its neutral role. The custodian's advocate (as in the *Jakob* case) is there to assist the court, and ask the questions that might be on the court's mind, because there is no one else in the court able to cross-examine the plaintiff's witnesses. That cross-examination role does not pit the custodian against the beneficiary. It simply tries to establish the facts to help the court reach its decision to the evidential standard. The custodian should not take a position on procedural questions such as evidential issues (for example in *Jakob*, some of the evidence was hearsay, which could carry lower weight, but was pressed by the bank in question). Rather, it should maintain its

neutrality on the provenance question throughout.

What will the court do?

The court can order the custodian to pay the beneficiary if it agrees that the funds are clean. This is a complete defence to any offence under AML legislation and the resultant Act of Court (or court order). Direction from the Royal Court will, in effect, stand as immunity from prosecution for the custodian. Most custodians, in their neutral role on the question of provenance, will follow any order the court may make. Most custodians will also keep the FIU informed of the proceedings, and the FIU will know that any Royal Court order will result in the monies being paid. There is no case in Guernsey recording an invention of the FIU to prevent this from happening.

Recovery of costs under contractual indemnities

A crucial question for the custodian is how its costs will be covered. The custodian is party to the proceedings through no fault of its own. It is there simply because it was complying with AML legislation and because the Court of Appeal has said aggrieved beneficiaries in this situation must bring a private law action. The only possibility of an adverse costs order is if the court finds its suspicion was fanciful or baseless.

Equally, the beneficiary has been forced to start proceedings because its funds have been frozen as per the legislation and it is confident of proving that the funds are clean. Most custodians will have terms and conditions which provide complete indemnity in favour of the custodian as a result of any costs incurred from legal or other action relating to the beneficiary. While there is no reported decision on this issue yet, it should be simple to determine whether those indemnities are part of the contract between the parties. If so, the simplest method (as in *Jakob*) is for the court to order the funds be paid to the beneficiary, minus the custodian's legal costs. This then becomes a question of quantum. This is a contractual indemnity, not a court order for indemnity costs, which is a different concept.

Can a custodian rely on its contractual indemnity to recover costs spent on legal advisers? Legal costs are often seen as a special category of debt which are not liquidated until they have been assessed by a court. This is the case in England, which is why solicitors can't bring insolvency proceedings against their clients for unpaid fees. They must instead bring civil claims so the sums claimed can be established as liquidated damages. There is no such concept in Guernsey. There are some cases (such as *Morgan v Bank Julius Baer (Guernsey branch) [2021] GRC 011*) where the court has commented that costs claimed under a contractual indemnity should be taxed or assessed before the final amount is established. But, clients cannot actually do this under Guernsey law or the rules governing the conduct of Guernsey advocates. The *Morgan* case was a fully adversarial injunction case and can be distinguished from these types of more neutral and less hostile types of proceedings. The question therefore remains untested.

Conclusion

Beneficiaries caught up in the AML regime will find, at first, a closed and somewhat cryptic system brought about by the (rightly so) strict AML laws which govern Guernsey's finance sector. It will then take substantial work to show that funds are not derived from criminal conduct. This could involve examining historical records and instructing expert forensic accountants to assist with a flow-of-funds analysis. This will be seen by some as a negative, but in the author's view it is a product of an robust, yet flexible, AML legislative framework. This could only be improved by introducing a time limit on the FIU to seize the funds in question. This would ease the administrative and cost burdens on banks and other financial institutions of being involved in civil proceedings so that their customer can demonstrate provenance.

About Ogier

Ogier is a professional services firm with the knowledge and expertise to handle the most demanding and complex transactions and provide expert, efficient and cost-effective services to all our clients. We regularly win awards for the quality of our client service, our work and our people.

Disclaimer

Key Contacts

Mathew Newman

Partner

Guernsey

E: mathew.newman@ogier.com

T: +44 1481 752253

Related Services

Legal

Dispute Resolution

Banking Disputes