

Tracing a new path - The Federal Republic of Brazil and Anor v Durant International Corporation and...

Insights - 19/12/2012

Tracing a new path - The Federal Republic of Brazil & Anor v Durant International Corporation & Ors

Jersey's Royal Court has delivered a landmark judgment¹, eschewing long established principles of common law concerning the circumstances in which proprietary claims may be established and when assets may be traced. In a clear statement of Jersey's jurisprudential independence, the Court found that legal interests are subject to equitable tracing rules, that funds may be traced through "black holes" and into mixed bank accounts, that "backwards tracing" is permissible and that the "lowest intermediate balance" principle does not apply in Jersey.

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 in Brazil (**Doleiros**) 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 received by them with knowledge of their tainted origin; alternatively on grounds of unjust enrichment or a proprietary claim to the Funds.

Decision

The necessary elements of a claim of knowing receipt in Jersey are substantially the same as in England. It is necessary to show that assets have been disposed of in breach of trust or fiduciary duty, that the assets received are traceable as the assets of the plaintiff and that the defendant knew of the breach of trust or fiduciary duty such as to render it unconscionable for the recipient to retain the benefit of the assets received. By contrast, in order to succeed on a claim for restitution based on unjust enrichment, guilty knowledge on the part of the recipient is not required, unlike in England. A proprietary tracing claim in Jersey may be brought where property is obtained by fraud in the course of a fiduciary relationship. Equity imposes a constructive trust on the recipient in such circumstances, allowing the plaintiff to trace the stolen property.

Having found that the Maluf's had participated in a fraud in Brazil and that the Maluf's knowledge could be attributed to the Defendants, the Court was required to decide whether the Funds were traceable.

The Court began by addressing the dichotomy that presently exists between decisions of the Privy Council (on appeal from Hong Kong) in *Reid*² and the English Court of Appeal in *Sinclair*³. The Privy Council had accepted that proprietary claims could be brought against bribes received by fraudulent fiduciaries. However, the English Court of Appeal had refused to follow this approach. The Jersey Court indicated that it was inclined to follow the Privy Council's judgment in *Reid*. However, it was not necessary to decide the point. The Funds had been obtained by the theft of the Plaintiff's own property, which was recognised by the English Court of Appeal in *Sinclair* as an exception to the general prohibition of proprietary claims being brought against fraudulent fiduciaries⁴. Furthermore, existing Jersey authority recognises that property obtained by fraud is held on constructive trust and is traceable in equity⁵.

The concept of a constructive trust and equitable interest arising in this way does not command collective approval amongst English judges⁶. However, the Jersey Court made it explicitly clear it should not hesitate to take advantage of the fact that it is not burdened with historical limitations that may apply in England. The Court stressed that it can adopt those features of English law that have proved their worth while rejecting those that have proved problematic and develop its own law of recovery and restitution of misapplied property in ways that accord with good sense and notions of justice.

The first step the Court took in further developing Jersey's own law of recovery was to abandon the historical distinction that exists between tracing legal and equitable interests. The Court saw no merit in burdening Jersey jurisprudence with a distinction that it considered to serve no useful function, only made for complexity and uncertainty, had its roots in a legal system devised by judges with differing philosophical views and jurisprudential backgrounds for which there was no equivalent in Jersey and remained unresolved after innumerable attempts by judges and academics to effect a satisfactory synthesis. The Court held that a single all-purpose tracing regime should apply in Jersey and that it should operate equally in relation to both legal and equitable interests.

The Court then considered what a claimant of a proprietary interest must establish in order to successfully trace assets. As a starting point, the Court made it clear that tracing is a matter of evidence, not law. In reliance upon this distinction, it held that the initial burden was on the Plaintiffs to adduce sufficient evidence to make out a prima facie case. Once the Plaintiffs had done so (and perhaps influenced by the fact that the Defendants tended no positive evidence as to an alternative, legitimate, source of the Funds) the evidential burden then shifted to the Defendants to displace the conclusion that would otherwise naturally follow. The Plaintiffs did not need to show the exact "step by step" route by which the Funds reached their destination in order to establish a prima facie case. Nor was their proprietary claim lost by the Funds passing through a "black hole" of unidentified Doleiros before arriving in the New York Account and being mixed with unrelated funds.

As the final three fraudulent payments into the New York Account occurred *after* the final payment was made to the Defendants, the question arose as to whether "backwards tracing" is permissible in Jersey. The English law on backwards tracing is not settled⁷. In a bold statement of the willingness of the Jersey Court to develop its own jurisprudence, the Court held that the appropriate way to address the subject was not by reference to "*what is or not conceptually possible or arguably supported by English authority*"⁸, but as a matter of evidence. The question is "*simply whether there is sufficient evidence to establish a clear link between the credits and debits in an account, irrespective (within a reasonable timeframe) of the order in which they occur or the state of balance of the account*"⁹. There is no limitation on how, as a matter of evidence, that link can be proved.

The Jersey Court did not see any cause to restrict the scope of this test by applying the "lowest intermediate balance" principle, which has long been recognised under English law¹⁰. This principle is founded on the concept that a claimant is only entitled to trace the lowest value of the money held between the date of its misappropriation and the date on which the claim is brought. Any further money paid into an account after it reaches its lowest level is conceptually said not to have been derived from the victim. However, the Jersey Court rejected this principle on the basis of justice and practicality. It considered that the principle may give a sophisticated fraudster the ability to defeat an otherwise effective tracing claim by manipulating the sequence in which credits and debits are made to and from the fraudster's bank account.

On the facts of the case, the Court found that the Funds were sufficiently linked with the fraud perpetrated in Brazil to be traceable. It did not matter that there was no evidence as to exactly how the Funds made their way from Brazil into the New York Account. Nor did it make any difference that the Funds were mixed with unrelated amounts in the New York Account, that the final three payments into the New York Account occurred after the final payment was made to the Defendants, or that payments to the Defendants out of the New York Account at times exceeded the proceeds of the fraud that had been received into it.

Consequently, the Court found the Defendants were liable to account to the Plaintiffs for the Funds

on the basis of constructive trusteeship, unjust enrichment and the existence of a proprietary claim.

Comment

The outcome of this case may have done justice between the parties, given the fact that the Court found there was clear evidence that the Plaintiffs had been defrauded by the Malufs. However, the wider implications of the Jersey Court's bold demonstration of jurisprudential independence remain to be seen.

The Jersey Court's approach may face difficulties in situations where numerous victims have been defrauded. In particular, it is not clear how the Court will apply the "clear link" test to differentiate between the rights of multiple victims with competing claims to assets of a mixed account. The Court's decision not to take a "first in first out" approach and rejection of the lowest intermediate balance principle may create real problems in this respect and may result in the rules applied in this case having to be confined to limited circumstances, rather than having universal application. Furthermore, the Court's enthusiasm for finding traceable proprietary claims in previously unrecognised circumstances will not be welcomed by those who may only have a personal claim against a fraudster, such as creditors. Holders of such personal claims may find that their rights to recovery are trumped by other parties with (previously unrecognisable) proprietary interests.

It is important that custodians, such as trustees and banks, are aware that the Jersey's law on asset recovery is now significantly different from that which exists in England and other parts of the common law world. Failure to recognise this may result in unforeseen personal claims being brought against custodians for unwittingly paying away assets that are subject to a traceable proprietary claim in Jersey.

The Defendants have indicated that they will be appealing the Royal Court's decision to the Jersey Court of Appeal.

Ogier acted for the Parties Cited.

1 *The Federal Republic of Brazil & Anor v Durant International Corporation & Ors* [2012] JRC 211

2 *Sinclair Investments (UK) Limited v (UK) Limited v Versailles Trade Finance Limited & Ors* [2011] EWCA Civ 347

3 *Attorney General for Hong Kong v Reid* [1994] 1 A.C. 324

4 op. cit. paragraph [88]

5 *Re Esteem Settlement* [2002] JLR 53

6 See *Shalson v Russo & Ors* [2003] EWHC 1637 at paragraph [110]

7 See *Bishopsgate Investment Management Limited v Homan* [1995] Ch 211

8 Paragraph [219]

9 Paragraph [219]

10 See *Roscoe v Winder* [1915] 1 Ch 62

▪

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

This client briefing has been prepared for clients and professional associates of Ogier. The information and expressions of opinion which it contains are not intended to be a comprehensive study or to provide legal advice and should not be treated as a substitute for specific advice concerning individual situations.

Regulatory information can be found under [Legal Notice](#)

Meet the Author



[Edward Mackereth](#)

Global Managing Partner

[Jersey](#)

E: edward.mackereth@ogier.com

T: [+44 1534 514320](tel:+441534514320)

Key Contacts



Nick Williams

Partner

Jersey

E: nick.williams@ogier.com

T: +44 1534 514318



Oliver Passmore

Partner

Jersey

E: oliver.passmore@ogier.com

T: +44 1534 514247