

RECAPTURING YOUR ASSETS

If you are a Retail or Commercial Bank or other Financial Institution, Company Director or Liquidator, you may have experienced at some stage the events depicted in one or more of the scenarios set out below:

A A Financial Institution

In January 2016 your customer applied for a loan secured on the assets that it intended to purchase with the monies advanced. In March 2016, you notified your customer that its application had been successful. However, unbeknown to you, before the loan agreement had been executed and the loan monies drawn down, your customer, using a credit line that it managed to obtain from another bank, purchased the intended assets. Shortly after your customer's undisclosed purchase, the relevant loan agreement was executed and a charge was placed on the assets that your customer allegedly intended to purchase. In or about October 2016, without notifying you, your customer sold the assets, purchased replacement assets and used the proceeds of the sale to repay the loan it had obtained to purchase the replacement assets. In December 2016 your customer became insolvent.¹

B A Company, Director or Liquidator

A former co-director of yours on the Board of an English company or a former director of an English company of which you are currently the Liquidator, misappropriated £1m from the company and paid it to company X in the BVI with which he was associated. A few days later company Y which is located in Latvia but has connections with company X transferred a similar sum in United States dollars, less a small sum deducted by way of bank charges and possibly commission (the "transferred monies"), to a US dollar bank account in Panama held by a family member of a longstanding business associate of the former co-director (the "family member"). The family member, at no stage, had any legal entitlement to receive the monies transferred to him. About 10 days later the family

¹ Based on the facts of **Agricultural Credit Corp'n of Saskatchewan v Pettyjohn (1991) 79 DLR (4th) 22 (Saskatchewan Court of Appeal)**

member, paid out US\$700,000 of the transferred monies from his Panama bank account to your former co-director,².

What steps can you take, in the case of each scenario, to recover your loss?

Introduction

Prior to the commencement of any proceedings to recover your assets or their value you must first satisfy the following requirements:

- Identify the misapplied asset or its proceeds. This may be achieved by artificial rules of evidence referred to as “following” and “Tracing”. “Following” is the process of identifying the same property as it is transferred from one person to another. Tracing on the other hand, is the process of identifying a new asset as the substitute for the original asset misappropriated by the wrongdoer

In both scenarios above, tracing would be the appropriate means of identification of the misapplied assets.

- Where you find that one asset has been exchanged for another you may have to elect to treat the substituted asset as representing the value of the original asset. In such event you will be regarded as tracing the value represented in the original asset into the substitute

For reasons which I shall deal with below, it may be necessary for you to make such an election in both scenarios.

- Establish your rights to the assets or monies lost. Historically different rules of following and tracing have been developed at common law and in equity. The primary difference is that at common law the rules do not permit monies to be followed through a mixed fund which contains monies belonging to you and the person who misappropriated those assets. It should be noted that the rules at common law and in equity cannot be applied interchangeably so as to allow you to rely on the equitable rules to follow money through a mixed fund when your attempt to do so at law has failed
- At common law you would need to demonstrate that you have a legal interest in the original asset. As stated above, if your customer or the former director paid your or the company’s money into a bank account which already contained money belonging to him, you would not be able to trace his money into any withdrawal from the account at common law. The position would be to the contrary if the former director withdrew money from the company’s account and paid it directly to a third party without paying it into any intermediate mixed fund.

² Based on the facts of **Relfo Ltd (In Liquidation) v Varsani [2014] EWCA Civ 360**

- In such circumstances you would have legal title which you could enforce by way of a possible action for restitution. Nevertheless, in contrast to the common law's negative position in relation to co-ownership of interests in mixed funds it recognises co-ownership in mixtures of fluid and granular fungibles (oil and grain)
- In equity you would need to show that either: (i) you had a distinct beneficial interest in or an equitable charge over the original asset, (ii) the original asset was held subject to a fiduciary relationship before it was misapplied, or (iii) the circumstances in which you were separated from the original asset generates a distinct equitable title, for example, where you paid money by way of a simple mistake which was known by the recipient who chose to say nothing³
 - Where a trustee, including a fiduciary or constructive trustee has misapplied your original asset and transferred it to a third person you would need to make an election. You could choose either to follow the original asset or enforce your equitable title to it; or to trace into the substituted asset in the possession of the trustee and enforce a proprietary remedy against it. Where the asset is in the possession of the customer or former director you have an election between two proprietary remedies: you could enforce an equitable lien against the asset for the value of the original asset which was applied to acquire it. Such a lien would be for the fixed amount of the original asset and does not change in value even if the substituted asset rises or falls in value. In the alternative, you could claim the entire beneficial ownership of the substituted asset under a constructive trust, in which case the value of the proprietary security would fluctuate as the value of the substituted asset changes
 - In those cases where your original asset can no longer be identified as still existing or where your equitable interest has been extinguished because a third party took your legal interest in it as a bona fide purchaser for value without notice, your only option would be to trace into the substituted asset in the possession of your customer or the former co-director

Comment

On the facts of both scenarios, you could opt for tracing in accordance with the equitable rules. Such a conclusion may be straightforward in the case of scenario **B**. However, in the case of scenario **A** there may be a temptation to assert that you have a legal charge over the original assets. This raises the issue of "backwards tracing". The general proposition in that regard is that where your proprietary interest in the asset has been extinguished by your customer or former director's by way of dissipation or the asset was sold to a bona fide purchaser for value without notice, it cannot be substituted for an interest in a different asset acquired by the wrongdoers prior to the misappropriation or changed into an asset that they acquire subsequently.

³ Snell's Equity, 33rd ed, 2015, 30-054, p788

What conclusion is the Court likely to reach in relation to each of the scenarios above?

Financial Institution

The Court stated in **Agricultural Credit Corpn** (“ACC”)⁴, with the approval of the Privy Council in **Brazil and Anor v Durant International Corpn and Another**⁵:

“...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 [monies advanced to them by ACC] 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 ACC. The Pettyjohns used [the moneys advanced] as part of a larger, commercially reasonable transaction to acquire rights in the 1981 and 1984 cattle. The fact that the use of [the moneys advanced] was, due to the nature of the transaction, after the acquisition of rights does not alter the conclusion that the [moneys advanced] were used to acquire those rights”.

In summary, the interposition of the bank in that case was simply to provide bridging finance to cover the time gap between the purchase of the assets and AAC’S funds being drawn down as had previously been arranged,

The Courts in the **Brazil** and **ACC** cases have indicated that they will not hesitate to mitigate the effect of the “backwards tracing” principle in appropriate cases where it is satisfied that the various steps are part of a co-ordinated scheme: “...[T]he availability of equitable remedies ought to depend on the substance of the transaction in question and not on the strict order in which associated events occur.”⁶

Company, Director or Liquidator

A Court is likely to make the following findings based on the facts of scenario **B**:

- (i) In theory there is no limit on the number of substitutions that can take place. Therefore there is no reason why the substituted product of your money cannot be traced through any number of accounts. However, in practice it would be advisable to adopt a more cautious approach as the number of substitutions and the fact that they do not occur in a chronological sequence may make it more difficult for the innocent party to substitute one asset for another ⁷;

⁴ (1991) 79 DLR (4th) 22 @ 38 (Saskatchewan Court of Appeal)

⁵ [2016] A.C. 297 PC [36]

⁶ *Ibid* [38]

⁷ *Relfo* [64]

(ii) Your company, as a beneficiary of a trust, is entitled to a continuing beneficial interest not simply in the trust property, namely, the £1m but also in its traceable proceeds. Moreover, your interest binds everyone who takes your property or its traceable proceeds except a bona fide purchaser without notice⁸;

(iii) A Court, on the facts of this scenario, will be entitled to draw an inference that not only were your company's funds paid into company Y's account but those monies were the source of the monies paid to the family member's account in Panama. To that end the Court could take into account the similarity of the amount and timing of the payments to company X and from company Y; that the amount paid to the family member was the same as the amount of the payment to company X less the small charge by way of bank charges and commission; and that the family member gave no consideration for receipt of the payment into his Panama dollar account⁹;

(iv) The Court could also draw inferences stemming from the fact that companies X and Y had previous connections with one another¹⁰;

(v) The Judge could make an inference that when your company had money on deposit with its bank i.e. it had the benefit of a debt owed to it by its bank (a normal bank/customer relationship), it exchanged that right for a debt owed to it by company X. The value of this latter debt would be based on company X having agreed to transfer that balance to another person at some future date in exchange for company Y making the company Y payment to the family member. In the circumstances it would not matter that company X would reimburse someone for the company Y payment only after company Y had made its payment because the company Y and the other payments made throughout the chain of substitutions were made on the faith that company X would provide the reimbursement. The authority for such a proposition is the case of **Agip (Africa) Ltd v Jackson [1990] 1 Ch 265 CA**. The decision in **Agip** indicates that in order to trace money into substitute assets it is not necessary that the payments should occur in any particular order or in chronological order¹¹; and

(vi) Both the former director and the family member could be liable for the misappropriation of the company's monies on the bases of fraud and knowing receipt, respectively.

What would be the quantum of your loss on the brief facts of Scenario C below?

Assume that the former director misappropriated £2m from your company and paid that sum into his own bank account which at that time contained no other monies.

⁸ **Ibid** [65]

⁹ **Ibid** [56]

¹⁰ **Ibid** [58]

¹¹ **Ibid** [61-63]

Shortly after depositing that sum he drew out £1m and dissipated the same. One week later he deposited £300,000 into his bank account which had been acquired from a wholly independent source. The total balance in that account then stood at £1,300,000.

Comment

Your proprietary claim would be limited to £1m, "the lowest intermediate rule", as the further deposit of £300,000 is not presumed to have replaced the £1m which he had dissipated previously.

The subject of following and tracing is as varied as it is complex. Consequently, I have limited the scope of those principles to the scenarios specifically mentioned in this article.

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