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A new direction for equitable tracing?

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Introduction

Equity's rules on tracing appear to have taken a new direction in recent years.[1] It is widely thought that there has been a departure from traditional tracing, based on direct substitution of one item of property for another.[2] Two cases, in particular, are said to demonstrate this: *Relfo Ltd v Varsani*[3] and *Federal Republic of Brazil v Durant International Corp*.[4] The suggestion here will be that neither case affords compelling support for a significantly new approach to tracing. And, indeed, the decision in the latter, more radical, *Brazil v Durant* case, purportedly based on tracing, is perhaps better understood as not involving tracing at all – despite what the court said.[5]

Traditional rules for tracing against wrongdoers through bank accounts

The most significant tracing rules in practice are those applicable where wrongdoers, on misapplying money in breach of trust or breach of fiduciary duty, pay it through bank accounts. It is perhaps helpful first to briefly state the key rules traditionally said to apply in this context, then explore the more recent case law.

The 'honest person' rule

Re Hallett's Estate[6] shows that if a wrongdoer mixes misapplied money in a bank account with their own money, personal expenditure from the account is taken to be their own money first, leaving the misapplied money in the account: it is therefore still traceable. The court said the

[1] The reference to 'equity's rules' is not intended to endorse the view that the common law's rules should be understood as different – it is simply a recognition that they are commonly said to be different.

[2] For textbook accounts, see: Lynton Tucker, Nicholas le Poidevin, and James Brightwell (eds), *Lewin on Trusts* (20th edn, Sweet & Maxwell 2020), paras 44.111-44.114. Paul Matthews, Charles Mitchell, Jonathan Harris, and Sinéad Agnew (eds), *Underhill and Hayton Law Relating to Trusts and Trustees* (20th edn, LexisNexis 2022), paras 94.40-94.46. Michael Bridge, Louise Gullifer, Gerard McMeel, and Kelvin FK Low, *The Law of Personal Property* (3rd edn, Sweet & Maxwell 2021), paras 32.055-32.057. Charles Mitchell, Paul Mitchell, and Stephen Watterson, *Goff & Jones on Unjust Enrichment* (10th edn, Sweet & Maxwell 2022), paras 7.69-7.79 (plus paras 7.35-7.39 and 7.45-746). Jamie Glister and James Lee (eds), *Hanbury and Martin Modern Equity* (22nd edn, Sweet & Maxwell 2021), paras 26.023-26.026. Graham Virgo, *The Principles of Equity and Trusts* (4th edn, OUP 2020), 601-604; and Paul S Davies and Graham Virgo, *Equity and Trusts: Text, Cases and Materials* (3rd edn, 2019 OUP), 890-92. Jessica Hudson, Ben McFarlane, and Charles Mitchell (eds), *Hayton, McFarlane and Mitchell on Equity and Trusts* (15th edn, Sweet & Maxwell 2022), paras 15.044-15.070. JE Penner, *The Law of Trusts* (12th edn, OUP 2022), paras 12.34-12.35. Charlie Webb and Tim Akkouh, *Trusts Law* (5th edn, Palgrave 2017), paras 14.11.3-14.12.1. Jonathan Garton, Rebecca Probert, and Gerry Bean (eds) *Moffat's Trusts Law: Text and Materials* (7th edn, CUP 2020), 623. Michael Haley and Lara McMurtry, *Equity and Trusts* (6th edn, Sweet & Maxwell 2020), para 17.052. Warren Barr and John Picton (eds), *Pearce & Stevens' Trusts and Equitable Obligations* (8th edn, OUP 2022), 870-72. Gary Watt, *Trusts & Equity* (9th edn, OUP 2020), 528. Alastair Hudson, *Principles of Equity and Trusts* (2nd edn, Routledge 2021), para 20.5.2. Monographs are: Aruna Nair, *Claims to Traceable Proceeds* (OUP 2018), paras 1.74-1.77 and 4.32-4.39; and Magda Raczynska, *The Law of Tracing in Commercial Transactions* (OUP 2018), paras 3.15-3.17.

[3] [2014] EWCA Civ 360, [2015] 1 BCLC 14.

[4] [2015] UKPC 35, [2016] AC 297.

[5] For another suggestion that it is not a tracing case, although with a rather different analysis of the decision, see Joe Campbell, '*Republic of Brazil v Durant* and the Equities Justifying Tracing' (2016) 42 Aust Bar Rev 32.

[6] (1880) 13 Ch D 696 (CA).

law assumes they are behaving honestly by using their own money when spending. Jessel MR, delivering the leading judgment, said:[7]

> '[N]othing can be better settled, either in our own law, or, I suppose, the law of all civilised countries, than this, that where a man does an act which may be rightfully performed, he cannot say that that act was intentionally and in fact done wrongly … When we come to apply that principle to the case of a trustee who has blended trust moneys with his own, it seems to me perfectly plain that he cannot be heard to say that he took away the trust money when he had a right to take away his own money.'

This could be called the 'honest person' rule. Smith, in the leading academic text on tracing, comments:[8]

> 'It should be noted that this principle is not a presumption of intention; it cannot be overcome by any contrary intention on the part of the wrongdoer, and in fact it does not relate to intention at all. It simply resolves evidential difficulties against the one who wrongfully created them.'

The 'lowest intermediate balance' rule

But once the wrongdoer's own money is gone from the mixture, further spending must be the misapplied money. *James Roscoe (Bolton) Ltd v Winder*[9] accordingly held that the lowest balance to which the account falls, before new money is paid in, is all that can traceably remain of the misapplied money. This is called the 'lowest intermediate balance' rule. A trustee paid £455 of trust funds into his private bank account. Personal expenditure then reduced its credit balance to £25. Later he paid in his own money and by his death there was a credit balance of £358. But it was held that only £25 could traceably remain of the trust money – this was the 'lowest intermediate balance' before other money was paid in.[10]

Virgo has argued that, on the logic of the 'honest person' approach, later payments into the account by the wrongdoer should be seen as the wrongdoer *restoring* the misapplied money, above the lowest intermediate balance level.[11] However, in *Roscoe v Winder* Sargant J said, for restoration to take place, there must be an actual intention to restore – the law will not deem one.[12]

(There is some authority that, when applying the 'lowest intermediate balance' rule, a claimant is not restricted to the balance *in the specific bank account their money was misapplied into* – if the wrongdoer has several accounts with the same bank, those accounts can be aggregated, so as to yield a higher overall balance due from the bank to the wrongdoer: *Cooper v PRG Powerhouse Ltd*.[13] But this decision appears to be per incuriam. Evans-Lombe J

[7] (1880) 13 Ch D 696 (CA), 727.
[8] Lionel D Smith, *The Law of Tracing* (OUP 1997), 78.
[9] [1915] 1 Ch 62 (Ch).
[10] Lionel D Smith, *The Law of Tracing* (OUP 1997), 265-67, examines practical problems that can arise with the lowest intermediate balance rule: transactions processed out of sequence by the banking system, and provisional transactions that may be cancelled.
[11] Graham Virgo, '*Re Hallett's Estate (1879-80)*' in Charles Mitchell and Paul Mitchell (eds), *Landmark Cases in Equity* (Hart 2012), 384. For criticism of such an approach, see Lionel D Smith, *The Law of Tracing* (OUP 1997), 82-85 and 201-3.
[12] [1915] 1 Ch 62 (Ch), 69 – a proposition approved many times since.
[13] [2008] EWHC 498 (Ch), [2008] BCC 588, [31]-[33], cited for this proposition by Paul Matthews, Charles Mitchell, Jonathan Harris, and Sinéad Agnew (eds), *Underhill and Hayton Law Relating to Trusts and Trustees* (20th edn, LexisNexis 2022), para 94.40.

specifically said in the case,[14] '… no authority against this contention in principle was adduced and I know of none. I propose to accept it.' But there was contrary authority, which although before the court in *Cooper v PRG,* was not cited on this point: *Shalson v Russo*.)[15]

The 'acquire then dissipate' rule

Re Oatway[16] decided wrongdoers cannot use the law's assumption that they spend their own money first to keep valuable property bought, if the balance of the account later becomes inadequate to refund the misapplied money, through dissipation: the misapplied money can be traced into the property acquired previously, to make good the inadequacy of the balance. A trustee mixed £3,000 of trust money with approximately £4,000 of his own money in his bank account. He purchased shares in his own name using £2,137 from the account. He then spent the remainder of the account for his own purposes and died insolvent. The trust was held entitled to trace into the shares. The court rejected an argument that purchase of the shares should be taken to be use of his own money first; and that it was therefore the trust money that was later dissipated from the account. This could be called the 'acquire then dissipate' rule.

The 'account balance sufficient' rule (or 'account balance first' rule?)

Turner v Jacob[17] decided that where a wrongdoer mixes misapplied funds with their own money in a bank account, so long as the account maintains a balance at least equalling the misapplied funds – or what now traceably remains of them – so that the account balance is sufficient to repay those funds, they are taken to remain in the account: that is, a claimant cannot say those funds should instead be traced into property purchased by the wrongdoer from the account, which has increased in value. A mother received £75,000 on trust for her daughter. The mother paid it into a bank account, mixed with her own money. The account balance was reduced to £10,000, without any assets being acquired with the money spent. The remaining £10,000 was treated as all being trust money held for the daughter (under the 'honest person rule'). But this was now all that traceably remained of the trust fund (under the 'lowest intermediate balance' rule). Although the account (or replacement accounts) thereafter always maintained a balance of at least £10,000 – that is, enough to satisfy the *remaining* trust fund – the daughter claimed that her £10,000 could be traced into the later purchase of a house by the mother funded from the account. It was decided that £10,000 in the account was held on trust for the daughter; she could not choose to trace that amount into the house instead. This could be called the 'account balance sufficient' rule. (Any temptation to call it the 'no cherry picking' rule should be resisted: although the expression 'cherry picking' has been used in this context, it is also sometimes used to describe *other* distinct scenarios – there is a risk of confusion.)[18]

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[14] [2008] EWHC 498 (Ch), [2008] BCC 588, [32].

[15] [2003] EWHC 1637 (Ch), [2005] Ch 281, esp [137]-[139], cited with approval by Lynton Tucker, Nicholas le Poidevin, and James Brightwell (eds), *Lewin on Trusts* (20th edn, Sweet & Maxwell 2020), para 44.111.

[16] [1903] 2 Ch 356 (Ch).

[17] [2006] EWHC 1317 (Ch), [2008] WTLR 307.

[18] So, it is sometimes suggested that *Shalson v Russo* [2003] EWHC 1637 (Ch), [2005] Ch 281, esp [144], approved 'cherry picking', obiter. But, although Rimer J used that expression, in context all he clearly approved was the 'acquire then dissipate' rule – not necessarily the *sort* of 'cherry picking' under consideration here – given that he said there (emphasis added) 'The justice of this is that, if the beneficiary is not entitled to do this, the wrongdoing trustee may be left with all the cherries *and the victim with nothing*.' (Examples of such suggestions are: Paul Matthews, Charles Mitchell, Jonathan Harris, and Sinéad Agnew (eds), *Underhill and Hayton Law Relating to Trusts and Trustees* (20th edn, LexisNexis 2022), paras 94.26-94.28. Charles Mitchell, Paul Mitchell, and Stephen Watterson, *Goff & Jones on Unjust Enrichment* (10th edn, Sweet & Maxwell 2022), paras 7.51-7.53. Michael Bridge, Louise Gullifer, Gerard McMeel, and Kelvin FK Low, The Law of Personal Property (3rd edn, Sweet & Maxwell 2021), para 32.047. Jamie Glister and James Lee (eds), *Hanbury and Martin Modern Equity* (22nd edn, Sweet & Maxwell 2021), para 26-021. Jessica Hudson, Ben McFarlane, and Charles Mitchell (eds), *Hayton, McFarlane and Mitchell on Equity and Trusts* (15th edn, Sweet & Maxwell 2022), paras 15.026-15.029.

Smith argues the 'account balance sufficient' rule is wrong: it is inconsistent with underlying principles of tracing law, which subordinate the interests of a wrongdoer mixer of property to those of an innocent party.[19] However, Whayman argues that *Turner v Jacob* is correctly decided; but that the decision does not reflect a *general* rule of tracing.[20] The decision to limit the claimant to a charge or lien over the bank account followed from the fact that, while there was a technical breach of trust by the wrongdoer mother in mixing funds, there was no breach of fiduciary duty involved. That is, the rules of tracing take account of the type of wrongdoing.[21]

An open question is whether this rule is correctly stated as an 'account balance *sufficient*' rule; or whether it will prove instead to be an 'account balance *first*' rule. That is, supposing the remaining account balance is not *sufficient* to replace the misapplied funds – or what now traceably remains of them – but it can replace a fraction of those funds, is a claimant bound to accept that faction *first*, before looking to trace into any assets purchased from the fund that may have increased in value?[22]

The 'fragmentation' rule

El Ajou v Dollar Land Holdings plc[23] is authority that where a wrongdoer mixes misapplied funds with their own money in a bank account, and then fragments the account into new accounts, or presumably purchased assets, the misapplied funds can be traced into *any* of the fragments. For example, if an account of £10m contains £2m in misapplied trust funds and £8m of the trustee's own money, and the total is transferred into 10 new accounts of £1m each, or used to make 10 simultaneous house purchase of £1m each, the trust can trace its £2m into *any* of these fragments. Millett J held:[24]

> 'The victims of a fraud can follow their money in equity through bank accounts where it has been mixed with other moneys because equity treats the money in such accounts as charged with the repayment of their money. If the money in an account subject to such a charge is afterwards paid out of the account and into a number of different accounts, the victims can claim a similar charge over each of the recipient accounts. They are not bound to choose between them. Whatever may be the position as between the victims inter se, as against the wrongdoer his victims are not required to appropriate debits to credits in order to identify the particular account into which their money has been paid. Equity's power to charge a mixed fund with the repayment of trust moneys … enables the claimants to follow the money, not because it is theirs, but because it is derived from a fund which is treated as if it were subject to a charge in their favour.'

Charlie Webb and Tim Akkouh, *Trusts Law* (5th edn, Palgrave 2017), para 14.11.2. Simon Gardner, *An Introduction to the Law of Trusts* (3rd edn, OUP 2011), 324).)

[19] Lionel D Smith, *The Law of Tracing* (OUP 1997), at 199-203. Paul S Davies and Graham Virgo, *Equity and Trusts: Text, Cases and Materials* (3rd edn, 2019 OUP), 880, agree, despite acknowledging that the wrongdoer will often be insolvent, so that in reality it would be their creditors who would be subordinated to the innocent party – saying the creditors can be in no better position than the wrongdoer.

[20] Derek Whayman, 'Obligation and Property in Tracing Claims' [2018] Conv 157, esp 173.

[21] While the mother had spent on her own personal expenses much of the daughter's trust fund, Patten J found, [42], 'I think it is highly unlikely that [the mother] had any real grasp of the intricacies of the law of trusts or of the need to separate trust money. It seems more likely that she regarded herself as under an obligation to account to [the daughter] for whatever was due to her when that time came.' And the mother had indeed amply recompensed the daughter under her will.

[22] AJ Oakley (ed), *Parker and Mellows: The Modern Law of Trusts* (9th edn, Sweet & Maxwell 2008), para 22.177, appears to see this as an 'account balance *first*' rule.

[23] [1993] 3 All ER 717 (Ch); reversed on other grounds [1994] 2 All ER 685 (CA).

[24] [1993] 3 All ER 717 (Ch), 735-36.

This could be called the 'fragmentation' rule.

Note that Millett J spoke specifically about a claim to an equitable charge or lien. *Lewin on Trusts* expresses reservations about whether this freedom to choose any fragment(s) extends to an alternative claim of (proportionate) ownership, so as to increase the value of the claim.[25] The right to elect to claim ownership, rather than simply enforce an equitable charge or lien, is, of course, *usually* given when tracing funds misapplied in breach of trust or breach of fiduciary duty against a wrongdoer: *Foskett v McKeown*.[26] Taking the illustration of fragmentation into houses given above, the question raised is whether the trust should be able to choose the two houses that have risen in value the most, and claim ownership of them, taking the increase in value; rather than being restricted to asserting against any of the houses an equitable charge or lien for (only) the amount the trust's funds originally misapplied into the account.

The 'no tracing into an overdraft' rule

Bishopsgate Investment Management Ltd v Homan[27] shows that money paid into a bank account so as to simply reduce its overdraft (without producing a positive balance in the account) is seen – in general, at least – as no longer traceable: an overdraft is viewed as a liability of the account holder, not an asset, so there is seen to be no asset to trace into. So, occupational pension trust money improperly paid into the bank account of the employers, which was overdrawn or later became overdrawn, could not be traced – at least on the information before the court. This is the 'no tracing into an overdraft' rule.

But in *Bishopsgate v Homan*, the Court of Appeal effectively left open the question whether tracing *through* an overdraft into some other asset paid for by expenditure from the overdraft might sometimes be possible. Dillon LJ thought such tracing *might* be possible;[28] Leggatt LJ rejected it;[29] and Henry LJ agreed with both judgments.[30]

The possibility of forward tracing through an overdraft

Dillon LJ suggested that conventional *forward* tracing through an overdraft might be possible, giving this example:[31]

> '[If] moneys misappropriated … were paid into an overdrawn account [of the wrongdoer] in order to reduce the overdraft and so make finance available within the overdraft limits for [the wrongdoer] to purchase some particular asset.'

There is an arguable case for recognising forward tracing through an *authorised* overdraft, on the basis that the usual treatment of such an overdraft – whereby it is characterised as simply a liability and not an asset[32] – is wrong. An authorised overdraft *is* an asset (albeit entailing a

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[25] Lynton Tucker, Nicholas le Poidevin, and James Brightwell (eds), *Lewin on Trusts* (20th edn, Sweet & Maxwell 2020), paras 4.081-4.083. The text calls it a form of 'cherry picking'.

[26] See [2001] 1 AC 102 (HL), 130-31, part of Lord Millett's leading judgment. But note that he said later, 132, 'It is not necessary [in the present case] to consider whether there are any circumstances in which the beneficiary is confined to a lien in cases where the fund is more than sufficient to repay the contributions of all parties.'

[27] [1995] Ch 211 (CA).

[28] [1995] Ch 211 (CA), 216-17. The examples given by the judge were questioned in Lionel Smith 'Tracing, "Swollen Assets" and the Lowest Intermediate Balance: *Bishopsgate Investment Management Ltd v Homan*' (1994) 8 TLI 102, 104 – although Smith supports 'backward tracing' in general: see below.

[29] [1995] Ch 211 (CA), 221-22

[30] [1995] Ch 211 (CA), 222.

[31] [1995] Ch 211 (CA), 216. Dillon LJ was adopting and approving, 217, views expressed by Vinelott J at first instance: [1994] Pens LR 179, [77], [79], [130].

[32] For example, *Shalson v Russo* [2003] EWHC 1637 (Ch), [2005] Ch 281, [140], where Rimer J said: '[I]t is not possible to trace into and through an overdrawn account, because such an account is not an asset at all: it is a

liability): it is a chose in action. Money a wrongdoer misapplies into an authorised overdraft, freeing up spending power within the overdraft limit, could be said to traceably survive within an asset to that extent. And, while no claim against it is possible while it exists only in the form of 'spending power', if the spending power is *used,* its use could arguably be traced into any asset later acquired by that spending power.[33]

The 'backward tracing' debate

Dillon LJ also suggested that 'backward tracing' through an overdraft might be possible. Backward tracing is – at least as usually understood – where a wrongdoer uses misapplied money to pay off an overdraft, or other debt, tracing back in time or direction into any asset the borrowing paid for earlier. He recognised:[34]

> '[The possibility of] "backward tracing" – where an asset was acquired [by the wrongdoer] with moneys borrowed from an overdrawn or loan account and there was an inference that when the borrowing was incurred it was the intention that it should be repaid by misappropriations…'

The immediate use of the misapplied funds was not to purchase an asset but to discharge a liability – paying off the debt obligation involved in the loan – so there is no asset acquired in direct exchange for the money to trace into. Backward tracing would involve saying: 'We can trace the misapplied money, backward through the debt, into the asset that borrowing paid for earlier'.

However, the expression 'backward tracing' is sometimes used in a wider sense: to mean *any* assertion the law should trace backwards in time or direction – even if no use of credit was involved, so there is no debt to trace 'through'.[35] By way of illustration, suppose a trustee wishes to fund a personal investment by stealing from the trust: however, while the investment opportunity only exists now, a chance to steal from the trust will not arise until next week. So, the trustee uses their own 'holiday fund' to make the investment; then steals from the trust to replace the holiday fund; then dissipates that fund by taking the holiday. Some would argue, given this was an overall plan to fund the investment from the trust's money, the law should trace the stolen trust money back in time or direction *as if* it paid for the investment.

The merits of backward tracing are debatable. In particular, Smith argues that it is always possible to trace payment of a debt backwards into any asset the debt previously paid for; or, alternatively, into the money originally borrowed, assuming it still exists unspent.[36] But Conaglen argues backward tracing should not be recognised: saying the authorities are against it, the law traces through assets not liabilities, and backward tracing would unduly give yet

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liability. The consequence is that the claimant cannot show that his money has become represented by an asset into which it is possible to trace: all his money has done is to reduce a liability, and so has ceased to exist.'

[33] See David Wilde, 'The Case for Tracing Forward Not Backward Through an Overdraft' (2023) 29 T&T forthcoming – where the implications for the lowest intermediate balance rule and for 'backward tracing' are explored.

[34] [1995] Ch 211 (CA), 216. Again Dillon LJ was adopting and approving, 217, views expressed by Vinelott J at first instance: [1994] Pens LR 179, [76], [130], [156]-[157].

[35] For example, see the description of this as 'a form of backward tracing', in Lynton Tucker, Nicholas le Poidevin, and James Brightwell (eds), *Lewin on Trusts* (20th edn, Sweet & Maxwell 2020), para 44.072.

[36] Lionel D Smith, 'Tracing into the Payment of a Debt' (1995) 54 CLJ 290. He elaborated on his views in Lionel D Smith, *The Law of Tracing* (OUP 1997), 353-56; and on how backward tracing works in the more complicated situation where an overdraft has paid for several assets, and only part of that overdraft is paid off using the claimant's money, 215-17.

more proprietary protection at the expense of the personal claims of an insolvent wrongdoer's creditors.[37]

When we come to the two cases focused on here, appearing to show a new approach to tracing, we shall see that *Relfo v Varsani*[38] arguably involved backward tracing, through a debt; and in *Brazil v Durant*,[39] the court explicitly said it was tracing backward – seemingly using 'backward tracing' in the *wider* sense identified above – and said that tracing backward is permissible within stated limits.[40] However, the suggestion here will be that neither case should be understood as involving backward tracing of any sort. So, the issues remain unresolved.[41]

The burden of proof

Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd[42] is authority that, where a wrongdoer misapplies funds in breach of trust or breach of fiduciary duty and mixes them in a bank account with the wrongdoer's money, the burden of proof, on a balance of probabilities, is on the wrongdoer to demonstrate what part of the account balance is the wrongdoer's own money. Accordingly, if the wrongdoer cannot discharge this burden, the whole balance can be regarded as traceable proceeds of the misapplied funds. Lord Neuberger MR, delivering the leading judgment, held:[43]

> 'Where he has mixed the funds held on trust with his own funds, the onus should be on the fiduciary to establish that part, and what part, of the mixed fund is his property … [O]nce it is shown that money held on trust for [the claimant] was paid into a "maelstrom" account [by the wrongdoer – a "maelstrom" created by a mass of account transactions designed to give the false impression of substantial trading turnover – then that wrongdoer bears] the burden of showing that money in that account is not that of [the claimant]. Both legal principle and fairness to other creditors of the defaulting fiduciary suggest that the extent of that burden should not be other than the normal civil standard of proof, namely the balance of probabilities.'

But *Serious Fraud Office v Lexi Holdings plc*[44] shows that if misapplied funds are found to have been paid out of an account they went into, the law does *not* go so far as to presume that a wrongdoer has mixed those moneys *somewhere* into the wrongdoer's general holding of assets, unless the wrongdoer proves the contrary, so as to justify tracing that money into *any* of the wrongdoer's assets.

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[37] Matthew Conaglen, 'Difficulties with Tracing Backwards' (2011) 127 LQR 432. He suggests that if backward tracing is to be allowed, it should be limited to situations where the wrongdoer *planned* from the outset using the misapplied money to acquire the traced asset.
[38] [2014] EWCA Civ 360, [2015] 1 BCLC 14.
[39] [2015] UKPC 35, [2016] AC 297.
[40] An attempt to survey the resulting law is *Serious Fraud Office v Hotel Portfolio II UK Ltd* [2021] EWHC 1273 (Comm), [21]-[48].
[41] The focus here will be on the *decision* reached in *Brazil v Durant*. There was a wider discussion of backward tracing in the judgment. A clear account is the case note by PG Turner, 'Tracing to and fro' (2016) 75 CLJ 462. These wider dicta in the case might also support tracing through an overdraft in a *forward* direction, to what is later obtained by use of the overdraft facility: see Lynton Tucker, Nicholas le Poidevin, and James Brightwell (eds), *Lewin on Trusts* (20th edn, Sweet & Maxwell 2020), para 44.113; and Charles Mitchell, Paul Mitchell, and Stephen Watterson, *Goff & Jones on Unjust Enrichment* (10th edn, Sweet & Maxwell 2022), para 7.37.
[42] [2011] EWCA Civ 347, [2012] Ch 453 (overruled on other grounds by *FHR European Ventures LLP v Cedar Capital Partners LLC* [2014] UKSC 45, [2015] AC 250).
[43] [2011] EWCA Civ 347, [2012] Ch 453, [138] and [141].
[44] [2008] EWCA Crim 1443, [2009] QB 376, esp [46]-[55].

Inferences

When tracing misapplied funds, if there are gaps in the evidence regarding tracing steps, the courts are, of course, entitled to draw common sense inferences about what probably happened – at times glossing over quite significant gaps. This is at least one aspect of the decision in *Relfo v Varsani* – critiqued at length below – that is uncontroversial and in line with past authority.[45]

The context of recent new approaches to tracing

Turning now to recent cases appearing to qualify these traditional tracing rules: responding to dishonest trustees and other fiduciaries increasingly trying to hide misappropriations in a complex set of transfers, making conventional tracing difficult. In *Brazil v Durant*, Lord Toulson JSC, delivering the judgment, said:[46]

> '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.'

Implicit backward tracing? – *Relfo v Varsani*

In *Relfo v Varsani*,[47] the wrongdoer was a director of the Relfo company. In breach of fiduciary duty, he misapplied £500,000 of Relfo's funds. The ultimate intended destination was the account of a business friend, Varsani. The intermediate steps could not be identified in full detail, but the court held that on a balance of probabilities the bulk of Relfo's money had traceably made this journey to Varsani's account.[48] However, there was an apparent difficulty. The alleged route taken by Relfo's money was into the account of a company called Mirren; from Mirren's account into the account of a company called Intertrade; and from Intertrade's account to Varsani's account. But the evidence indicated that Intertrade's final payment to Varsani was made *before* the traceable proceeds of the Relfo misapplication could have reached the Intertrade account from the Mirren account. The inference was drawn that Intertrade made its payment to Varsani *first*; and, by prior agreement with Mirren, was then *later* reimbursed with the traceable proceeds of Relfo's money from Mirren.

This seems to involve an issue of timing, with the appearance of backward tracing. How could Intertrade pass on to Varsani what Intertrade had not yet received? However, this way of thinking about things involves a misconception. As natural as it may be when looking at bank transfers of funds, when tracing Relfo's money we should *not* believe that we need to identify the *transfer* of some *continuously identifiable* fund. Instead, tracing happens through substitutions, typically *exchanges*. When a simple bank transfer is made, it is an *exchange* that is being traced through rather than a transfer of anything in a continuous form: the balance in the account of the transferor, a chose in action they hold against their bank, is *exchanged* through the banking system for a balance in the recipient's account, a *different* chose in action they hold against their bank.[49] So we need to identify the specific *exchange* that the crucial step in *Relfo v Varsani* involved. The inferred agreed exchange arranged by Mirren with Intertrade was an exchange of payments: Intertrade will pay Varsani £500,000 and in exchange Mirren

[45] [2014] EWCA Civ 360, [2015] 1 BCLC 14, [56] – following the approach taken by Millett J in *El Ajou v Dollar Land Holdings plc* [1993] 3 All ER 717 (Ch) and endorsed on appeal [1994] 2 All ER 685 (CA).
[46] [2015] UKPC 35, [2016] AC 297, [38].
[47] [2014] EWCA Civ 360, [2015] 1 BCLC 14.
[48] Minus 1.3% – seemingly a commission deducted for money laundering services by an intermediary.
[49] *Foskett v McKeown* [2001] 1 AC 102 (HL), 127-28.

will pay Intertrade £500,000 (being in fact the traceable proceeds of Relfo's money). Suppose instead this was an agreed exchange of physical objects – a table for a chair. There is no doubt that ownership of the table is traceable into ownership of the chair, because one was exchanged for the other. *And we would not care which item was delivered first*. Similarly with an agreed exchange of payments, it does not matter which was made first: one was still exchanged for the other and is therefore traceable into it – regardless of timings.[50]

The suggestion that this was a case of backward tracing involves saying that there was not simply an agreed exchange of payments, one payment for the other. Instead, technically, at the time of Intertrade's payment to Varsani, the agreed exchange with Mirren was – not a *payment* of the equivalent amount to from Mirren to Intertrade – but rather *a promise* from Mirren to Intertrade to pay an equivalent amount. This promise amounted to a debt owed by Mirren to Intertrade, this debt being the first asset received by Intertrade in the transaction. When payment of the debt was made, the debt was discharged; and that payment of money was now traceably substituted for the debt, the money being a second asset received by Intertrade in the transaction. So, on this view, when identifying substitutions we have to trace backwards, from the payment to Intertrade, *through that prior debt incurred to Intertrade*, to reach the earlier payment made by Intertrade to Varsani. That is, the traceable chain of substitutions was: payment of the traceable proceeds of Relfo's money to Intertrade,[51] then backwards through the contractual obligation to make that payment held by Intertrade as a debt due to it, which the payment discharged and therefore substituted for; to the payment in exchange for which that debt had been incurred, and which it was therefore substituted for, that is the payment from Intertrade to Varsani.[52]

A number of objections can be made to this backward tracing analysis of the case. First, there was no suggestion by the court that they believed they were tracing backwards through this route. The key passage in the leading judgment of Arden LJ contains no mention of backward tracing and is, it is suggested, consistent with the suggestion that the transaction was viewed as simply an agreed exchange of payments, in which the order of the payments did not matter:[53]

> '[M]oneys held on trust can be traced into other assets even if those other assets are passed on before the trust moneys are paid to the person transferring them, provided that that person acted on the basis that he would receive reimbursement for the moneys he transferred out of the trust funds … [I]n order to trace money into substitutes it is not necessary that the payments should occur in any particular order, let alone chronological order. … [A] person may agree to provide a substitute for a sum of money even before he receives that sum of money. In those circumstances the receipt would postdate the provision of the substitute. What the court has to do is establish whether

[50] Any attempt to trace the route of a 'transfer' – rather than an 'exchange' – would also run into another problem. As the court observed [2014] EWCA Civ 360, [2015] 1 BCLC 14, [13]: 'Intertrade could have had other accounts'. Intertrade might have been reimbursed into an entirely different account it held, so that there is then not only a problem of timing but of *location* for tracing a 'transfer' – the money paid by and to Intertrade would never have been in the same account; in addition to the payments being in the wrong order. (Although the potential existence of other accounts also raises the possibility that Intertrade was in fact paid in advance – to another account – rather than being reimbursed later. The evidence only showed that Intertrade could not have been paid in advance from the traceable proceeds of Relfo's money *into the specific account* from which Intertrade made its payment to Varsani.)

[51] Or more fully, the exchange through the banking system of a chose in action held by Mirren against its bank, for a chose in action held by Intertrade against its bank.

[52] Or more fully, the exchange through the banking system of a chose in action held by Intertrade against its bank, for a chose in action held by Varsani against his bank.

[53] [2014] EWCA Civ 360, [2015] 1 BCLC 14, [63].

> the likelihood is that moneys could have been paid at any relevant point in the chain in exchange for such a promise.'

Secondly, if we are to focus on contractual technicalities, these were money laundering arrangements, in which both Mirren and Intertrade were seemingly knowing participants.[54] Presumably no enforceable contract, or debt pursuant to it, arose from the agreement between Mirren and Intertrade. Following *Patel v Mirza*,[55] it is, of course, less than wholly predictable which contracts will be found unenforceable for illegality.[56] But have we reached the point where a money launderer – acting ultimately to facilitate tax evasion – can sue for reimbursement of disbursements made on behalf of a client and have their claim enforced in a court of law? So, apparently, there was no debt to trace backwards through: this was simply an agreed exchange of payments.

Thirdly, we shall assume that there *was* an enforceable debt owed by Mirren to Intertrade. If so, part of the general case in favour of backward tracing must be that, money paid over as repayment of debts owed to credit providers – such as banks – often cannot be traced, because the credit provider was a bona fide purchaser of the money received: therefore backward tracing into any asset paid for by the credit previously provides the only viable route for tracing. But Intertrade, the credit provider here, while it may have given value, can hardly have been acting bona fide. So there was a right for Relfo to trace the proceeds of its misapplied funds against Intertrade. If backward tracing is to be, *at most*, a restricted possibility, as case law so far indicates, arguably this is a situation where it should not be available – where it would be a *supplementary* alternative to direct tracing.

Finally, even if none of this is accepted, Nolan rightly emphasises that:[57]

> 'Rules of attribution—including the tracing rules—exist for a purpose, and their content is informed by that purpose. The core purpose of the equitable tracing rules is to identify assets for the purposes of a claim to redress a breach of trust.'

He demonstrates that the treatment of a transaction for the purpose of equitable tracing will not – and should not – necessarily correspond to a minute dissection of the same transaction for the purpose of identifying the parties' contractual rights against one another: pointing out that 'equity looks to substance not form'.[58] Indeed, Penner argues that, if we painstakingly attend to contractual technicalities, practically every sale of an asset involves backward tracing: since the vast majority of sales are technically an exchange of promises rather than an exchange of money for assets.[59] It is submitted that the law should not overcomplicate tracing in this sort of way; and the obvious substance of the transaction in *Relfo v Varsani*, for the purposes of tracing, is that one payment was exchanged for another. There was no backward tracing; and the decision is entirely consistent with traditional tracing rules.

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[54] See the first instance judgment of Sales J [2012] EWHC 2168 (Ch), esp [59] (although cf paras [65]-[67]).

[55] [2016] UKSC 42, [2017] AC 467. Assuming a scenario where English contract law principles apply.

[56] James Goudkamp, 'The End of an Era? Illegality in Private Law in the Supreme Court' (2017) 133 LQR 14.

[57] Richard Nolan, 'Civil Recovery after Fraud' (2015) 131 LQR 8, 10. (This quote is reproduced and expanded on in RC Nolan, 'The Administration and Maladministration of Funds in Equity', in PG Turner (ed), *Equity and Administration* (CUP 2016), quote at p 81.)

[58] Richard Nolan, 'Civil Recovery after Fraud' (2015) 131 LQR 8, 11. For the maxim 'Equity looks to the intent rather than to the form' see John McGhee and Steven Elliott (eds), *Snell's Equity* (34th edn, Sweet & Maxwell 2020), para 5.013.

[59] James Penner, '"Sort of" Backwards Tracing' in Paul S Davies and James Penner (eds), *Equity, Trusts and Commerce* (Hart 2017), 126-27.

Intention-based tracing? – *Brazil v Durant*

In *Brazil v Durant*,[60] the basic facts were that a mayor took bribes and therefore held \$10.5m on constructive trust for the city. He admitted he had carried out a plan to transfer it from one account ('the source account') to two other accounts ('the destination accounts') – falsely claiming it was not bribe money at all. The Privy Council held the city was entitled to trace \$10.5m into the destination accounts.[61] Tracing was permitted even though (1) twice, transfers from the source account were for amounts *higher than* the lowest intermediate balance in the source account since the bribe money was paid in (in other words, parts of those two transfers had clearly not come directly from the bribe money – some of the bribe money paid into the source account had been taken out and later replaced by funds from another source before these transfers to the destination accounts – so the lowest intermediate balance rule was being disregarded); and even though (2) the last three payments of bribe money into the source account had happened *after* the final transfers outwards from the source account towards the destination accounts (in other words, those last three transfers towards the destination accounts could not have come directly from the bribe money – this money transferred towards the destinations account must have been from another source, and the bribe money had presumably been used to repay that source – so backward tracing was taking place).

Lord Toulson JSC, delivering the judgment, accepted that the lowest intermediate balance rule is generally valid and that there is a general rule against backward tracing:[62]

> 'The defendants' 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.
>
> Conceptually the defendants' argument is coherent and it is supported by a good deal of authority.'

But he then laid down this apparent exception, deciding the case on this basis:[63]

> 'If the court is satisfied that the various steps are part of a co-ordinated scheme, it should not matter that, either as a deliberate part of the choreography or possibly because of

[60] [2015] UKPC 35, [2016] AC 297.

[61] There was an ambiguity over exactly where the \$10.5m was traced to. There was a series of transfers totalling \$13.1m from the source account to the first destination account, which was held by a company called Durant; and then a series of transfers totalling £13.5m from the first destination account to the second destination account, which was held by a subsidiary company called Kildare. At times the claimant's case was stated to be that all \$10.5m had travelled through the first destination account and ended up in the second destination account (eg, [2015] UKPC 35, [2016] AC 297, [7]); but the claim was against, and judgment was given in respect of, both destination accounts, suggesting the \$10.5m was seen as fragmented between the two accounts in amounts not specified – a lack of specificity that was justifiable under the 'fragmentation' rule.

[62] [2015] UKPC 35, [2016] AC 297, [17]-[18].

[63] [2015] UKPC 35, [2016] AC 297, [38]-[40].

> the incidents of the banking system, a debit appears in the bank account of an intermediary before a reciprocal credit entry … [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 …
> But the claimant has to establish a co-ordination 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 reasoning seems to involve a new form of intention-based 'tracing': whereby the transactional intentions of the wrongdoer were effective to characterise the money in the destination accounts as the misapplied trust funds. But, it is suggested, this is not a process that can be encompassed within the word 'tracing', either according to its natural meaning, or as traditionally understood in the law: this has always involved pursuing an unbroken chain of substitutions; and it has pointedly not been concerned with intention in this way.

What happened in *Brazil v Durant* was instead, seemingly, that the wrongdoer accumulated in the destination accounts a fund that he admitted he *identified in his mind* as the misapplied trust money.[64] But, as the outcome of various movements of money under his control, the accumulation in the destination accounts was not, in fact, all derived by a chain of substitutions from the originally misapplied funds: some of it, observably, came from other sources. In other words, the wrongdoer *replaced* part of trust funds with other money – while, mentally, nevertheless still conceiving of what arrived in the destination accounts as the misapplied trust money. There are rules about *replacing* misapplied funds with other funds – which is what was really going on. We saw that it was recognised in *Roscoe v Winder*,[65] that a wrongdoer can *intentionally replenish* depletions made to a misapplied fund. And these rules about replacement *are* fundamentally concerned with intention – by way of contrast to tracing rules, as conventionally understood. As Smith explains:[66]

> '[R]ights can also be acquired by intention. Thus, if a trustee deposits money to an account with a genuine intention that the resultant credit will be the subject matter if a trust, there is no reason that this intention should not be effective. The beneficiary acquires equitable proprietary rights, but not through tracing … [A] rule governing the acquisition of rights by intentional transfer is not a rule about tracing, which is not controlled by intention.'

Since, (1) replacement was what actually happened, and (2) the court wished to decide the case according to the intentions of the wrongdoer, it is suggested that these *intentional replenishment* rules are what the court should have focused on – a point developed below. But this was not how the case was argued. Instead, the court stretched the law's quite separate tracing rules *well beyond breaking point*.[67]

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[64] Although, it will be recalled, his defence was that these funds were not misapplied trust property at all – he asserted they were legitimate brokerage commissions, which was rejected. This form of defence explains why he was willing to concede that he identified the funds assembled in the destination accounts as the money in question.
[65] [1915] 1 Ch 62 (Ch), 69.
[66] Lionel D Smith, *The Law of Tracing* (OUP 1997), 202-3 (referring to *Roscoe v Winder* – note omitted).
[67] It is perhaps revealing that one major practitioner work, John McGhee and Steven Elliott (eds), *Snell's Equity* (34th edn, Sweet & Maxwell 2020), deals with *Brazil v Durant* in *both* its account of tracing (based on what the court said), para 30.061, *and* its account of the intentional replenishment rules (dealing, it is suggested, with the substance of the decision), para 30.057.

Why the case did not involve 'tracing'

The difficulty of seeing the decision in *Brazil v Durant* as based on tracing – and accordingly the desirability of reinterpreting it – is perhaps best demonstrated by the point that, the case's new intention-based tracing looks to be on an inevitable collision course with traditional substitution-based tracing. In essence, the law is in danger of inadvertently promising the same item of property two *different* claimants – one claimant through the older precedents, but an entirely different claimant through the new case law. For example, suppose the wrongdoer in *Brazil v Durant*, having diverted some of the originally misapplied funds elsewhere, made good this depletion by making his final payment to the destination accounts *from money misappropriated from a second trust fund, intending to replace that from other sources later*. We now have a situation where, money from the second trust fund has, in breach of trust, been paid directly into the destination accounts: and, on the most elementary of traditional tracing rules, that second trust can, of course, trace its money into the destination accounts. But, at face value, according to *Brazil v Durant*, since this was a step taken in carrying out an overall plan to get the $10.5m misapplied from the original, first trust to the destination accounts, the first trust can trace into *exactly the same money*.

Equally, the law is also in danger of inadvertently identifying a single claimant's property as being *in two different places at the same time* – one location through the older precedents, but an entirely different location through the new case law. For example, suppose we knew that in *Brazil v Durant* the fraction of the $10.5m bribe money alleged by the defence not to be traceable into the destination accounts on traditional tracing rules – the 'missing' $2.8m, replaced in the destination accounts by money demonstrably coming from other sources – in fact ended up with a money laundering company by a chain of direct substitutions. According to intention-based tracing, this $2.8m ended up in the destination accounts; but according to traditional substitution-based tracing it ended up with the money laundering company. Suppose further – for entertainment value – that the money laundering company had placed the $2.8m into a hugely successful investment, so that it was now worth $28m; meanwhile the destination accounts had been entirely dissipated, with all of those involved with the accounts insolvent.

A new approach of intention-based tracing has its advocates. In particular, Cutts supports the recent cases on pre-planned dealings; arguing focussing on intention is the usual way to understand transactions:[68]

> 'The ordinary [legal] approach to the characterisation of transactions is to look to the transactors' intentions to determine the content and type of transaction that they have created, deduced from consideration of the transaction as a whole. If this intention reveals that the parties intended several steps to operate as one, overarching, transaction, the intermediate steps are typically ignored.'

However, her principal examples are commercial transactions, such as contracts, where the law, *of course*, generally implements the intentions of parties: the aim of the law is to provide a framework of justice within which to *facilitate* their intended commercial dealings. But, the law has no interest in facilitating the intentions of wrongdoers, which will invariably be self-serving. The point is made by Lord Sales:[69]

[68] Tatiana Cutts, 'Tracing, Value and Transactions' (2016) 79 MLR 381, 398.

[69] Now a Justice of the Supreme Court, but writing extrajudicially while a Lord Justice of Appeal: Philip Sales, 'The Future of Tracing: Practical and Conceptual Issues' [2017] RLR 183, 186-89 (notes omitted).

> 'Cutts [above] argues that, in establishing a legally sufficient transactional link, the courts should be "guided centrally by the intention of the transacting parties" … [But], it is not obvious why the ability of a claimant to trace into and assert rights to some new asset should *always* depend on the intention of the fraudster who diverted the claimant's original asset for improper purposes. That might open up scope for the fraudster to defeat fair recognition of property interests. For instance, should property rights in relation to a collapsed Ponzi scheme, such as that operated by Bernie Madoff, depend upon whether he had favourites among his investors whose interest he sought to promote in allocating assets between accounts? This does not seem right. So perhaps a focus on the intention of the persons entering the transaction ought to operate by a species of estoppel or evidential rule (where it would be unjust for them to deny that property rights have been transmitted via the route they themselves chose as part of a scheme, where the recipient is either a knowing participant or at any rate a volunteer recipient), but subject to an overriding principle that the court will not accept the effectiveness of what they have purported to do if there is another more obviously just solution.'[70]

It can be added to Lord Sales' critique that, if a wrongdoer's intention *is* to guide tracing, it might conceivably militate *against* tracing – just as it can facilitate it. Let us take a hapless wrongdoer like the lay executor trustee in *Re Tilley's Will Trusts*,[71] who thoroughly confused trust money with her own money in her bank account, while dealing in property on her own account, all the time enjoying extensive overdraft facilities. Suppose she pays into her empty account £100K of her own money plus £100K of misapplied trust money. She then pays the £200K from the account to buy an asset, leaving the account again empty. The traditional tracing rules are tolerably clear that the trust can trace into the asset. But suppose our trustee did not 'intend' to use the trust's money: she saw herself as using her overdraft facility to buy the property, and thought of the trust's £100K as still – notionally – in her account. Ungoed-Thomas J stated the law in these terms in *Re Tilley*:[72]

> 'It seems to me that if, having regard to all the circumstances of the case objectively considered, it appears that the trustee has in fact, *whatever his intention*, laid out trust moneys in or towards a purchase, then the beneficiaries are entitled to the property purchased and any profits which it produces to the extent to which it has been paid for out of the trust moneys.'

Is tracing now governed by the trustee's intention instead; so that the trust has no right to trace into the purchased asset?

The closest analogy identified by Cutts in support of a new approach to tracing based on intention – where we can say the law is not seeking to facilitate a party's intention but to hold them accountable for it – is the so-called judicial 'new approach to tax avoidance',[73] also known as 'the Ramsay principle'.[74] But the support offered is questionable, given what an

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[70] The concluding suggestion made by Lord Sales in this quotation is not a million miles away in its purport and effect from the reinterpretation of *Brazil v Durant* that will be offered here.
[71] [1967] Ch 1179 (Ch).
[72] [1967] Ch 1179 (Ch), 1193, emphasis added. He found on the facts that this was not what had happened in that case. For a possible rationalisation of the problematic decision in the case, see David Wilde, 'The Case for Tracing Forward Not Backward Through an Overdraft' (2023) 29 T&T forthcoming.
[73] Tatiana Cutts, 'Tracing, Value and Transactions' (2016) 79 MLR 381, 399. Called a new approach in *IRC v Burmah Oil Co Ltd* (1981) 54 TC 200 (HL), 214.
[74] From the seminal case of *Ramsay (WT) v IRC* [1982] AC 300 (HL).

incoherent mess this area of law descended into. This doctrine did involve, at least on its classic formulation, inserted steps within a planned transaction being 'disregarded' to focus on the substance of an intended 'end result';[75] at least until this classic formulation was declared by a unanimous Supreme Court of seven judges to be too rigid,[76] and replaced with a very nebulous formulation[77] – there having been decades of inconsistent case law at the highest level of appeal in between. This included, in particular, an attempt to distinguish 'mitigation' from 'avoidance',[78] a distinction later found 'unhelpful'.[79] An attempt to limit reconstructions of events to what was 'realistic' and 'intellectually possible',[80] a limitation that was simply ignored in later cases.[81] And an attempt to distinguish 'commercial' concepts from 'legal' concepts,[82] a distinction that again proved unsustainable.[83] While uncertainty in the law may – arguably – be 'no bad thing', to serve as a deterrent when all that is in issue is the taxation consequences for tax avoiders,[84] the depressingly unclear and erratic body of case law produced by the new approach to tax avoidance does not serve as an inspiring exemplar for how *property rights* should be determined – often in a contest between equally innocent parties, such as between an insolvent wrongdoer's victims and creditors. To the contrary, this body of case law demonstrates the *difficulties* that arise when courts disregard the ordinary legal categorisation of events, classified according to general legal principle. In any case, this new approach to tax avoidance – with its disregarding of intervening events – was ultimately authoritatively declared an exercise in statutory construction, with statutory authorisation, rather than common law reasoning[85] (no matter how implausible this actually was).[86] And it is perhaps worth noting that it was subsequently felt desirable for statute to directly supervene in this rather dysfunctional area of the law, with the introduction of the 'General Anti-Abuse Rule' in Finance Act 2013.[87]

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[75] *Furniss v Dawson* [1984] AC 474 (HL), 527. Lord Brightman, delivering the leading judgment, formulated the new approach to tax avoidance as follows: 'First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax – not "no business effect." If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.'

[76] *Tower MCashback LLP 1 v R&C Comrs* [2011] UKSC 19, [2011] 2 AC 457 (SC), [42]-[43].

[77] The clearest reformulation in the *Tower MCashback* case was given by Lord Walker JSC, delivering the leading judgment, at [67]: '… in the context of a complex pre-ordained transaction … the court is concerned to test the facts, realistically viewed, against the statutory text, purposively construed.'

[78] Esp *Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655 (HL), 675.

[79] *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6, [2003] 1 AC 311 (HL), [62].

[80] *IRC v Fitzwilliam* [1993] 1 WLR 1189 (HL), 1202.

[81] And bluntly described as wrong by Lord Templeman: *R v IRC, ex p Matrix-Securities Ltd* [1994] 1 WLR 334 (HL), 345.

[82] *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6, [2003] 1 AC 311 (HL), esp [49]-[58].

[83] *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, [2005] 1 AC 684 (HL), [38]; *Tower MCashback LLP 1 v R&C Comrs* [2011] UKSC 19, [2011] 2 AC 457 (SC), [49].

[84] John Tiley, commenting on the*Tower MCashback* case in All ER Rev 2011, *Taxation* section, para 24.2.

[85] *Craven v White* [1989] AC 398 (HL), 510, 520, and 529.

[86] Calling the new approach to tax avoidance a 'principle of statutory construction' did not seem credible. At the time, the classic *Furniss v Dawson* formulation assumed one already knew what the statute meant; it was about reconstructing events before one applied the statute. It was about how to approach tax avoidance schemes; not how to approach statutes. Lord Carnwath 'The Journey to Fiscal Enlightenment' (2019) 40 Stat Law Rev 213, 218, observed later: 'To me at least it seemed clear that [*Furniss v Dawson*] could not be explained by reference simply to statutory interpretation. It had to be something more, because it involved not just interpreting the statute in a purposive way but reinterpreting the facts. One had to pretend that the intervening steps, though admittedly effective in "business" terms, had not happened.'

[87] Part 5 (ss 206-215) and Sched 43.

Reinterpreting the case

If we do wish to find a justification for the decision in *Brazil v Durant*, then with the benefit of hindsight it is submitted that – as suggested above – we need to start from the intentional replenishment rules: *replacement* of the misapplied funds was what was really going on.

If a trustee improperly depletes trust assets, and it is contended that the trustee has later replaced them from the trustee's own property, the case law indicates two elements are required for an effective intentional replenishment. First there must be an intention to transfer beneficial title to the property into the trust. Secondly, this must be accompanied by an act appropriating the property to the trust, although the appropriation need not be communicated to anyone. In *Re Cozens*,[88] Neville J said: 'the Court must be satisfied that a present irrevocable declaration of trust has been made…' And in *Taylor v London and County Banking Co*,[89] Stirling LJ, delivering the leading judgment, said the test was: 'Was an appropriation actually made … or did it rest only in intention? … [S]uch a transaction may be good though not communicated by a trustee to his beneficiaries.'

The wrongdoer in *Brazil v Durant* plainly did not intentionally replenish the trust on this test. His state of mind, when procuring transfers of money into the destination accounts, was not an intention to transfer title to the trust, with a view to duly administering the fund. It was, at most, merely a mental *identification* of a fund as his ill-gotten gains. (Although had the relevant intention been demonstrably present, the mere act of transferring the money into the destination accounts would surely have been a sufficient act of appropriation, in the light of that proven intention.)

It is submitted that, stripping away the inappropriate language of 'tracing', what *Brazil v Durant* has effectively decided is that the law now goes *beyond* these intentional replenishment rules. There is now *another* way in which misapplied funds can be treated as effectively replaced. This might be called a doctrine of 'premeditated reconstruction'. If a wrongdoer, having misapplied funds, *plans* ('premeditated') to collect what the wrongdoer identifies as the funds – or, of course, part of them – in an account, the law will recognise the account balance as being those funds, notwithstanding that the original misapplied funds were *replaced* ('reconstruction') with other funds along the way. That is, the wrongdoer *identifying* money as the misapplied funds when paying it into – or procuring its payment into – an account is, effectively, recognising it belongs to someone else: and the law will act on that implicit acknowledgement of title against the wrongdoer.

An explanation of *Brazil v Durant* based on 'premeditated reconstruction' is – in addition to not being what the court actually said – admittedly somewhat artificial: it involves equating an *implicit recognition of title* with an *intention to transfer title*. But any artificiality here seems considerably less than the artificiality involved in saying that we are 'tracing'. Recognising premeditated reconstruction *does seem to be the gist of what the court has sanctioned*.

If we do treat the actions of a wrongdoer such as that in *Brazil v Durant* as legally effective reconstruction of misapplied funds, then in a case where the wrongdoer is insolvent, the trust would nevertheless retain its insolvency priority. Under the Insolvency Act 1986, s 340(4), given that the wrongdoer's actions were undertaken with a view to the wrongdoer *keeping* the trust property, rather than a *desire to benefit the trust*, it would not amount to a 'preference' that could be set aside. And the reconstruction explanation of *Brazil v Durant* put forward here does not run into the problem we encountered with the tracing explanation: if a wrongdoer purports to reconstruct misapplied funds *using someone else's money*, that person

[88] [1913] 2 Ch 478 (Ch), 486.
[89] [1901] 2 Ch 231 (CA), 254.

can obviously trace the money – one can only effectively replace property *with property one is entitled to use*.

Is there inconsistency in the line of argument made here?

The arguments made here are open to accusations of inconsistency. In relation to *Relfo v Varsani*,[90] the suggestion here is that we should pay attention to the reasoning of the court and the absence of any reference to backward tracing there; whereas in relation to *Brazil v Durant*,[91] the suggestion is we should disregard the reasoning of the court and its explicit reliance on tracing. But that is standard academic technique: we assume that what a court says is good law unless we can expose a flaw in the reasoning – and hopefully that has been done. And in relation to *Relfo v Varsani*, the suggestion here is that we should pay attention to the substance of the transaction and disregard the minutiae; whereas in relation to *Brazil v Durant*, the suggestion is that we cannot disregard the facts there in favour of some alleged intended 'substance'. But looking to the substance is surely a matter of degree. In *Relfo v Varsani*, everyone can agree there was a basic exchange of payments, and the issue is, when characterising it, should the law of tracing be forced into a painstaking and potentially difficult analysis of the contractual detail, of the sort that can produce a mild headache, attempting to identify the precise steps; and whether it is appropriate to require such an approach from busy practitioners, often seeking to unravel a much larger, complex overall web of transactions against wrongdoers, when even academics with the luxury of time to contemplate are left unsure whether they have reached the right conclusion on the precise steps in the end. But in *Brazil v Durant*, it is much harder to see a clear 'substance' amounting to an exchange. Admittedly, Nolan's initial response (to the – then – 'very recent decision') was to justify it as 'a single transaction … exchanging a credit at a New York bank for a credit standing to the account of the defendants.'[92] But, with respect, the present writer does not read the case that way. The wrongdoer, in effect, seemingly moved money from one account under his control to other accounts under his control. At the level of the wrongdoer, there was a *transfer* of location within his own pool of assets, rather than an *exchange* – one cannot conduct an exchange with oneself. Moving down a level to the parties used by the wrongdoer, the basic transfer – ignoring the issues about the lowest intermediate balance rule and backward tracing – was from an account controlled by the wrongdoer's son in New York, to the account of one company in Jersey, then – all or at least much of the money[93] – onwards to the account of a second (subsidiary) company in Jersey, both companies being 'under the practical control of [the wrongdoer] and/or his son'.[94] No exchange seems to be involved at the level of these parties: the movement of funds from New York to Jersey was in one direction only with nothing apparently passing back in exchange.[95] Moving down to the level of the banks instructed by the parties used by the wrongdoer, there was never a simple exchange of a credit balance in the source account controlled by the son at the New York bank, exchanged by that bank, through the banking system, for a credit balance in the final destination account of the ultimate recipient company's bank in Jersey. Indeed there was no transaction at all between those two accounts, given the intervening company. And even if there were understood to be such an exchange, it was known to have been executed by multiple transfers *and the credit balance in the source account simply could not, at the relevant times, have included the disputed part of the bribe money, given the lowest intermediate*

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[90] [2014] EWCA Civ 360, [2015] 1 BCLC 14.
[91] [2015] UKPC 35, [2016] AC 297.
[92] RC Nolan, 'The Administration and Maladministration of Funds in Equity', in PG Turner (ed), *Equity and Administration* (CUP 2016), 87-89.
[93] Above, n 61.
[94] [2015] UKPC 35, [2016] AC 297, [1]. (Both companies used the same bank.)
[95] Although cf, at first instance in the Jersey Royal Court, *Republic of Brazil v Durant* [2012] JRC 211, [80].

balance rule and backward tracing problems affecting the source account. At no level can the present writer see in *Brazil v Durant* a simple, straightforward basic exchange *of the funds sought to be traced*. The tracing problems in *Brazil v Durant* were real and substantial, and the details accordingly important. It was not a simple case like *Relfo v Varsani*, where it would be nothing more than tiresome to dissect the precise contractual sequencing.

Conclusions

If the arguments here are correct, *Relfo v Varsani*[96] is an orthodox tracing case: it was a simple exchange of one payment in return for another – there was no backward tracing through a debt. And *Brazil v Durant*[97] is – despite what the court said – best understood as not being a tracing case at all. The decision did not involve the *tracing* of trust assets, but instead their *replacement* with – demonstrably – *other funds*. The case effectively recognises that, if a wrongdoer, having misapplied funds in breach of trust or breach of fiduciary duty, *plans* to collect what the wrongdoer *identifies* as the funds in an account, the law will recognise the account balance as being those funds, notwithstanding that the original misapplied funds were, in fact, *replaced* with other funds of the wrongdoer along the way. A new doctrine of giving legal effect to a wrongdoer's 'premeditated reconstruction' of a fund.

Suggestions that equitable tracing has started on a new course may, accordingly, be misplaced.

[96] [2014] EWCA Civ 360, [2015] 1 BCLC 14.
[97] [2015] UKPC 35, [2016] AC 297.