Privy Council Clarifies When Innocent Third Parties are Liable to Victims of Fraud

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To what extent must a bank make inquiries as to the commercial purpose of a transaction, particularly a transaction involving an offshore structure? And when is a bank liable to compensate a victim of theft for receiving funds deriving from stolen assets and using them for its own benefit?

These were the questions addressed in *Credit Agricole v Papadimitriou* by the UK's Privy Council (the court of final appeal for the UK's overseas territories and Crown dependencies, and for Commonwealth countries that have retained it as the ultimate appeal Court; its decisions are authoritative in English law as it comprises judges from the UK Supreme Court).

The Privy Council upheld a decision that the Claimant was entitled to recover US$9.8 million from Credit Agricole (the "Bank"), which the Bank had received and used to repay a loan made to the fraudster. It did so despite the absence of any dishonesty by the Bank.

The impact of the judgment may reverberate around the risk departments of financial institutions (or, indeed, other regulated entities). It is relevant where stolen funds, or funds deriving from stolen assets, have been used, for example, (a) to discharge a loan or overdraft, (b) to pay substantial fees for a transaction or (c) where the bank has enforced security taken over a stolen asset.

The dispute

The dispute concerned the sale of an art deco furniture collection belonging to the Michailidis family. The parents owned the collection, but it was in the possession of their son, Christo Michailidis. In 2000, after Christo's death, his partner fraudulently misappropriated and sold the collection for US$15m.

US$10.3m of the sale proceeds was deposited at the Bank via a convoluted series of transactions implemented by the fraudster:

- US$10.4m was paid to a Panamanian company.
- US$10.3m of those funds were withdrawn in cash and paid to an account held by a Liechtenstein foundation that had recently been acquired by the fraudster.
- That foundation transferred the US$10.3m to the Bank's Gibraltar branch into an account opened for a newly incorporated BVI company controlled by the fraudster.
- The Bank's London branch then loaned US$9.8m to another company owned by the fraudster, against the security of the sum deposited at the Bank's Gibraltar branch.
- The US$9.8m was apparently used to discharge an earlier loan taken out by that company with a separate bank.
- The loan made by the Bank was subsequently repaid to it from the funds held at the Bank's Gibraltar branch (meaning the Bank received the funds "beneficially").

The family discovered the fraud and commenced proceedings against the Bank in Gibraltar in April 2004, presumably because it was unlikely to recoup the money from the fraudster. The claim was made in three ways, two of which failed because the claimant could not establish sufficient "wrongdoing" by the bank (the failed claims were "knowing receipt" and "dishonest assistance": see our briefing on these types of claim here).

The foundation for the successful claim for the return of $9.8m was that, as the Claimant owned the collection, it had a "proprietary" (ownership) right not only to the collection itself, but also to the proceeds of sale. Those proceeds of sale had been paid to the Bank to discharge the loan.

The Bank's defence was that it was a "*bona fide purchaser for value* ***without notice***", i.e. it was an innocent party that acquired the assets without notice of the victim's rights. That is an established defence to a proprietary claim of this nature, and is a test which seeks to balance the competing rights of innocent parties caught-up in the wrongdoing of a fraudster. A bona fide purchaser for value with notice takes an asset free of earlier rights.

The issue was what constituted "***notice***". There are three categories of notice:

- First, actual notice, where the defendant actually appreciates that someone else has a proprietary right, but carries on with a transaction regardless;
- Secondly, constructive notice, where a reasonable person in the defendant's position (i.e. with its expertise and experience) would have appreciated on the facts available to it that a proprietary right probably exists; and
- Thirdly, another form of constructive notice, where the defendant should have made inquiries or sought advice which would have revealed the probable existence of a proprietary right.

This case concerned the third category. The question was in what circumstances and to what extent it can properly be said that the Bank should have made further inquiries.

Two different tests were proposed:

- Lord Clarke, giving the main judgment of the Privy Council, concluded that "*The bank must make inquiries if there is a serious possibility of a third party having* [a proprietary right] *or, put in another way, if the facts known to the bank would give a reasonable banker in the position of the particular banker serious cause to question the propriety of the transaction."*
- Lord Sumption sought to formulate the test in another way: *"… if there are features of the transaction such that if left unexplained they are indicative of wrongdoing, then an explanation must be sought before it can be assumed that there is none."*

Time will tell which version prevails. However, for the purposes of this case, the Bank was found wanting on both accounts.

The Bank claimed that its investigation into the ***source of the funds*** did not uncover anything improper, and that the size of the transaction would not have raised suspicion. A reputable person, who happened to be a non-executive director of an affiliate of the Bank, had (unwittingly) introduced the fraudster. The Bank had undertaken some due diligence on the fraudster and had reason to believe he was wealthy. It was unaware of the collection. The sums involved were not unusual, nor was it unusual to make a loan to repay another bank against the security of deposited funds. There was nothing, the Bank said, to arouse suspicion.

These arguments were accepted by the Judge that first determined the case, albeit he did conclude that there had been a somewhat lax approach to KYC (know your customer), including insufficient inquiry into the wealth of the customer and a failure to comply with internal procedures, partly because of the reputable source of the introduction.

However, the Privy Council criticised the Bank's focus on the source of funds. Its decision ultimately turned on whether the Bank had given sufficient attention to an entirely separate question, namely the commercial purpose of the transaction. Ostensibly that purpose was to repay a loan owed to another bank.

The Privy Council agreed with the finding of Gibraltar's Court of Appeal that the structure of the transaction was far too complex for the simple repayment of a loan. There was no obvious requirement for multiple transfers involving Panama, Liechtenstein, and the BVI, all of which would have incurred fees, or the payment of around £180,000 (net of interest) to the Bank for a straight-forward transaction. Banks are required to pay attention to complex unusual patterns of transactions which have no obvious economic or visible lawful purpose.

The conclusion was that the result of a reasonable inquiry into the commercial purpose of the transaction would have made it obvious that it was probably improper. Further, the Privy Council agreed that the web of legal entities and the cost would have alerted a reasonable bank to money laundering.

Lord Sumption underlined the importance of this Judgment when he noted that these principles would not just apply to proprietary claims, but also when ascertaining whether a Bank had sufficient "knowledge" to be liable for knowing receipt (see our briefing on civil claims, including "knowing receipt", here). It can be inferred that he would also have concluded that there would have been sufficient knowledge on the part of the Bank to make good a claim in knowing receipt, if that question had been before the Court and the other ingredients of the claim satisfied.

He also emphasised that claims of notice and knowledge are highly sensitive to their legal and factual context. The question is whether there is something which the defendant knows which "calls for an inquiry". A defendant bank cannot say there might well have been an honest explanation, if it has not made any inquiry at all.

Summary

This is an important and potentially far-reaching decision of a Court consisting of Judges from the UK's Supreme Court.

An honest bank, which had unknowingly received stolen funds and used them to repay a loan it had made, must compensate the victim of theft. It must do so because it failed to investigate the commercial purpose of the transaction under which it received the funds in circumstances where the unnecessarily complex structure and cost of the transaction were indicative of money laundering.

This case dealt with the proceeds of sale of artworks stolen from a private collector. It could equally apply to assets or funds stolen by a public official from a bank, or to bribes, which the bank has used for its benefit, for example to pay fees or to pay-off a loan or overdraft. A bank facing a claim from an aggrieved state could be found liable if it failed to seek an explanation when it had serious cause to question the proprietary of a transaction.

The rationale of the case is not, however, applicable where the Bank has simply received funds into a customer's account and transferred them away on the customer's instructions. In those circumstances, a claim would only be available against the Bank if it has been dishonest (e.g. "dishonest assistance" or "unlawful means conspiracy" - explained in our note here).

Finally, it is noteworthy that the Privy Council reached its decision applying the standards of money-laundering legislation in place in 2000, not the much higher requirements that apply under the present money-laundering regime. In our view, this suggests that the courts will apply a much higher standard to more recent conduct.

The case reference is *Credit Agricole v Papadimitriou* [2015] UKPC 13, and the case is available here.

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