WAYS AND MEANS OF TAKING SECURITY OVER BANK DEPOSITS

Comment by

BARRY McWILLIAMS

Stephen Jaques Stone James
Solicitors, New South Wales

If we assume that Broad's case has correctly decided that an instrument creating a charge over moneys deposited with the bank is not able to be registered or confer the benefits of registration, we need to look at the position of the bank as to any way in which it can ensure that it will have recourse to that deposit to satisfy both present and future obligations which are owed to it by the customer.

George Forster has mentioned the need to ensure that the deposit can't be withdrawn. This is obviously basic, because a number of the obligations will be future obligations of the bank and in the absence of any express contractual arrangement with the customer, the customer would be entitled to withdraw his deposit. Set-off wouldn't operate in that case because the debts would not both be due.

As George said, the "flawed asset" approach has been introduced to try and defer the contractual right of the customer to take the deposit away. The flawed asset approach seems to be effective against creditors; both judgment creditors and assignees and people getting attachments. The reason for this is that there doesn't seem to be any difference between the rights of assignees and creditors seeking attachment to the position of the customer itself. If the customer has no right to withdraw, those people trying to claim under him, would also have no right.

The problem with the flawed asset approach arises in a liquidation. While the British Eagle v Air France decision is not directly in point, it at least indicates that the rules in a liquidation are paramount, and prevail over conflicting contractual arrangements between the bank and the customer.

The essence of a liquidation is that the liquidator will get in any assets of the company and will distribute those according to the respective entitlements of the various creditors. It is very difficult to see that a court would allow the flawed asset approach to override that principle and give the bank a preference over other unsecured creditors or to allow the

liquidation never to be finished because the debt could never become repayable.

I wish to turn now to the question of set-off. A banker has a general right to combine accounts. This is subject to certain limitations; either implied limitations or express contractual arrangements between the bank and the customer.

An example of one of the implied limitations arises in the context of a term deposit and the current account. A bank can't off-set a term deposit against the current account as this could produce the result that the customer's cheques may not be able to be met because there are no funds available. It is important that the bank, if it is seeking to obtain the benefit of set-off, creates some contractual arrangement with the customer, which will entitle it to combine accounts or to set-off the deposit against all present and future liabilities.

If Broad's case is correct, this type of arrangement for obtaining security is not a charge which is required to be registered for it to be effective. The court considered that the instrument was not a mortgage or charge but was merely a contractual right of set-off. This contractual right of set-off is valuable, but if not coupled with the flawed asset device, it is subject to some risk so far as the bank is concerned.

For example, in the case of an attachment creditor, the rights of that creditor would prevail over the bank, because the set-off would only operate in relation to moneys which are due as at the time that the bank receives notice of the attachment. Similarly, in the case of assignees of that debt, the time at which the bank receives notice of the assignment is the crucial time in determining whether or not the set-off will operate.

It is now necessary to look at the effect of liquidation. As a basic rule, contractual rights of set-off do not apply in a liquidation. Liquidation has its own rules of set-off. The statutory provisions, which in the case of New South Wales are imported into the Companies Code by section 86 of the New South Wales Bankruptcy Act, apply to specify the requirements to be satisfied for set-off to operate in a liquidation.

These requirements are rather general but appear to operate more restrictively. There is a requirement for mutuality and there may also be problems under section 86(2) which attempts to prevent set-off being allowed in circumstances where either at the time the credit is given, or at the time the credit is received, the bank had notice of an available act of bankruptcy.

This latter aspect creates a difficulty in the case of a company because it is hard to determine what relevance it may have. As you know, companies are not normally subject to "acts of bankruptcy". If the importing of those provisions means that you do need to have regard to "acts of bankruptcy" that seems to be a further risk for a bank wishing to rely on set-off against a liquidator.

I hope it can be seen from the comments I have made that rights of set-off, even if coupled with a flawed asset device, are not entirely satisfactory. They do not give the same comfort as a bank would have if it had an effective registered charge. As there is criticism of Broad there must be some doubt as to its correctness. I think it would be prudent for the instrument which is creating these rights of set-off, in fact to be registered in case it is an instrument creating a charge.

This will at least give an opportunity, if Broad's case is incorrect, that the bank holding the instrument will have its full security rights and have a position of preference as a secured creditor in a liquidation. If Broad's case is wrong, and the instrument does in fact constitute a charge and it isn't registered, those rights of course will be ineffective in a liquidation, because that instrument will be void for non-registration. The fact that it is void, of course, won't deprive the bank of its normal right of set-off, but it needs to be remembered that the rights of set-off which the bank will have in a liquidation are the statutory rights and not its full contractual rights.