BROAD'S CASE AND SET-OFFS

JOHN KING

Russell McVeagh McKenzie Bartleet & Co
Solicitors, Auckland, New Zealand

Introduction

The document which was considered by Lee J. in Broad's case [1] was entitled "Security over Deposits with 'own' or 'other' Bank or with any Corporation". This heading in itself demonstrates the confusion which often exists when banks and other financiers seek to obtain security for advances against moneys deposited by or otherwise payable to a customer. The type of security that can be taken by a lender over moneys payable to a customer by that lender is fundamentally different from the security that the lender can take over moneys payable to the customer by third parties. Failure to recognise this essential distinction can result in incorrect security documentation, an incorrect analysis of the legal requirements to ensure the creation of valid securities and also confusion with the proper implementation of the lender's remedies under its securities.

The most common form of security utilised by financiers is the mortgage or charge. Where security is sought over moneys payable to a customer by a third party, the financier can obtain a charge over the customer's rights against the third party. However, where the moneys over which security is sought are payable to the customer by the financier itself then it is not possible for the financier to take security by way of charge. [2] Moneys deposited with a bank or any other financier should not be seen as identifiable bank notes the property of the customer held by the financier. Once the deposit is made the moneys become the property of the financier. What the customer has is, in fact, a chose in action - the right of the customer to enforce repayment of the deposit in accordance with the terms of the deposit. As Lee J. pointed out in Broad's case [3] it is well established that it is not possible for the financier to take a charge over its own liability - its liability to repay the deposit. If one analyses what in fact the financier wishes to do, it is simply to obtain the right to modify the contractual liability to repay the deposit so as to be able to deduct from the financier's liability the amount of the customer's liability; in other words, the right to set-off the customer's liability against the financier's liability.

In Broad's case the document utilised by the bank included within the one document two entirely different types of security - a charge over the customer's deposits with third parties [4] and a right of set-off over the customer's deposits with the bank. [5] Whilst this can be done, and in fact in Broad's case the two different types of security were properly created in separate clauses, nevertheless the practice does not assist those who use security forms, particularly standard printed forms, to appreciate the fundamentally different nature of the securities that are being granted. The document in Broad's case is misleading in referring to the customer as "the Mortgagor" when there was no question of a mortgage in relation to the customer's deposits with the bank. In fact, it is likely that if the document had been restricted to the granting of rights of set-off against the customer's deposits with the bank and had used terminology appropriate to that purpose, the Commissioner's claim that the document constitutes a "loan security" under the Stamp Duties Act may well not have arisen at all.

Set-Off at Law

In Broad's case the bank was granted the right to set-off the customer's indebtedness to the bank against the bank's indebtedness to the customer. This right of set-off is commonly called a contractual right of set-off and this was the description given by Lee J. in Broad's case. [6] However, whilst the term "set-off" is often used in a broad sense so as to refer to the deduction of a debit from a credit, the term has a more restricted meaning at law. The right of set-off in respect of liquidated sums stems from the old Statutes of Set-Off enacted in 1729 and 1734. [7] This form of set-off is confined to cases of "mutual debts". The requirements of the law are that both the debit and the credit must be for liquidated amounts and must also be due and payable. The right has a procedural basis enabling a defendant to defend a plaintiff's claim by setting-off against the plaintiff's claim a debt due by the plaintiff provided that the debt met the requirements of the Statutes. A defence of equitable set-off may be available in the case of unliquidated demands but the complexities of equitable set-off do not arise where the debts are both for liquidated sums.

At law, therefore, set-off can provide a measure of security where advances are made to a customer who has in turn made deposits with the lender. No documents are necessary to enable the set-off which exists by operation of law. However, the protection is limited by the requirements of mutuality - at the time the lender wishes to be repaid by the customer the customer's deposit with the lender must also be due and payable. If the customer's deposit is a term deposit and the deposit has not reached maturity then no set-off is available.

Combination of Accounts

Bankers and other financiers should be aware of the situations that can arise which are analogous to set-off but which do not at law amount to set-off. It is a well established principle that a banker who runs a number of current accounts for a customer can combine these accounts thereby setting-off credits and debits even if the account be operated at different branches of the bank in question. [8]

Combining of accounts is not set-off at law; it is in fact simply an accounting exercise to determine the balance of the customer's account with the bank. Buckley L.J. in the Halesowen case [9] expressed it as follows:

> "Nor is it a set-off situation, which postulates mutual but independent obligations between the two parties. It is an accounting situation, in which the existence and amount of one party's liability to the other can only be ascertained by discovering the ultimate balance of their mutual dealings."

Buckley L.J. refers to a set-off situation as postulating "mutual but independent obligations". In other words, debits and credits between the same parties which arise out of independent transactions where the liabilities created by those transactions have both matured. However, the law recognises the operation of current accounts by banks as not being independent transactions but a course of dealings where it is simply an accounting exercise to determine the ultimate balance between the bank and its customer.

With accounts other than current accounts the position is different. If the customer arranges a term loan or makes a term deposit he makes separate contractual arrangements in respect of the loan or deposit. These contractual arrangements clearly segregate the loan or deposit from the customer's current account. The loan or deposit and the current account are recognised by the Courts as independent obligations; they are distinct and separate accounts and by their very nature cannot be combined. [10] In this situation the right of set-off possessed by the bank (or the customer) is a true right of set-off at law. As a result if the bank loan has matured it will not be able to be set-off against a bank deposit that has not matured.

Contractual Set-Off

This expression is used where the parties, by contract, agree to permit debts to be set-off one against the other where at law set-off would not have been permitted. [11] The nature of the set-off in Broad's case is a clear example. Clause 1 of the Security Agreement expressly authorised the bank "at any time and from time to time" to deduct the customer's indebtedness to the bank from his deposits with the bank. Set-off would only have been permitted at law if the deposit had reached maturity at the time the loan was due for repayment.

The principles behind contractual set-off are clearly the same principles that resulted in the rule permitting bankers to combine current accounts. [12] By contract the parties have destroyed the segregated and independent nature of the debts. The Security Agreement has varied the original contract of deposit which is made part of an overall contract with the bank, encompassing the customer's rights in respect of the deposit and his obligations in respect of his indebtedness to the bank.

It is no longer a situation of set-off at law which as Buckley L.J. said in the Halesowen case "... postulates mutual but independent obligations". The obligations are no longer independent; by virtue of the Security Agreement it is now simply a question of determining the balance due between the parties. [13]

Security Rights under Set-Off

The differences between a charge and set-off and the differences between set-off at law and contractual set-off have various important consequences.

Set-off, whether at law or by contract, is not a charge and is not, therefore, subject to the various common law and statutory requirements respecting charges. Charges often require some form of registration to ensure validity; and there may be duty questions as in Broad's case. Charges are subject to questions of priority in relation to other charges; and upon liquidation of a company certain charges may rank behind preferential creditors nominated by statute. Securities based on set-off principles can avoid many of these difficulties and provide an advantageous form of security. However the security afforded by set-off is subject to its own particular difficulties.

Disputes as to the validity of set-off rights can arise in relation to other securities. The fundamental principle of set-off is that of mutuality. The right of set-off must have arisen prior to the intervention of the competing security.

The simplest example is the case where a customer with loans from a bank has also made deposits with that bank but has not entered into any contract to define the terms governing set-off. The bank's right of set-off at law against the customer's deposits only arises when the deposits mature. If prior to that date the customer assigns or charges those deposits to a third party then the bank's potential right of set-off will be defeated. The point to be emphasised is that the right of set-off at law is too limited to be relied upon as an acceptable form of security.

A more complex example is contained in the case in the Supreme Court of New South Wales Direct Acceptance Corporation Limited v. Bank of New South Wales.[14] In this case the bank agreed to freeze an overdrawn account and agreed to the establishment of a new working account. A term of this agreement was that there would be no right of set-off of the overdrawn account against any credit balance in the working account. When a receiver was appointed the bank sought to combine the two accounts alleging that its right to do so revived upon the customer's entry into receivership. The Court held that the right did not revive upon entry into receivership unless a provision to that effect had been agreed or was to be implied. As the Court held that this was not the case the receiver was entitled to the credit balance in the working account. The right of set-off, or more correctly, the right to combine the two current accounts which would otherwise have existed, had been negated by the agreement between the parties and this agreement did not provide for a right of set-off prior to the intervention of the third party charge.

If set-off is to be an adequate form of security it needs to be created by contract and that contract must ensure that the right of set-off exists from the outset so that it cannot be defeated subsequently by the rights of third parties. The key to the advantageous nature of the security offered by contractual set-off lies in the analysis of the true nature of contractual set-off. As the right is not strictly one of set-off but simply a question of determining the balance due at any time between the parties, any third party such as a receiver will be able to obtain rights only against that balance.

The Direct Acceptance Corporation case also highlights the need for precision when making arrangements relating to credit and debit accounts. If a financier is only prepared to make special arrangements on the basis that it must have a right of set-off which arises prior to the intervention of third party securities, then this can be achieved if the contractual arrangements clearly give this right.

Insolvency

Comprehensive rights of set-off also arise under the insolvency legislation in countries such as the United Kingdom, Australia and New Zealand. Those rights of set-off are more extensive than rights of set-off at law. [15] For example, the rights of set-off exist in relation to debit and credit accounts notwithstanding differing maturity dates.

The effect of the insolvency legislation can lead to unusual results. For example, in the Direct Acceptance Corporation case if the company in receivership was also in liquidation, then as between the bank and the receiver the bank would still have had no right of set-off as against the receiver. However, in the event of the receiver being paid in full leaving a surplus remaining in the working account, then the bank under the insolvency legislation would have had a right of set-off of its frozen account against the surplus thereby giving the bank priority over other unsecured creditors. [16]

Conclusion

The need for a clear understanding of the securities that a lender is obtaining is indeed self evident. However, if any example is required then the case of Estate Planning Associates

(Aust) Pty. Ltd. v. Commissioner of Stamp Duties (NSW) [17] is an excellent example. This case involved a document under which a trustee of a retirement fund which owned a life assurance policy sought to borrow moneys from the life assurance company concerned upon the security of the policy. The document shows that the draftsman was quite unsure as to the essential nature of the securities. The operative portion of the document uses the words:

> "We, the policy owner, hereby release the above policy as collateral security to ..."

Clause 4 gets closer to recognising set-off:

> "From any sum payable under the policy specified, APA Life Assurance Limited may retain the total amount of the loan secured by the policy ..."

Clause 5 then provides that if the moneys owing exceed the surrender value of the policy then:

> "... the policy shall thereupon become absolutely void."

Faced with a document of this nature the Judge had some difficulties in analysing the true nature of the security. He found that the document did not operate as an assignment or transfer of property and was not a mortgage for the purposes of the Stamp Duties Act, but he does not actually categorise the document as being in effect one of contractual set-off. It appears, however, that the essential nature of the document is one of set-off and many difficulties and perhaps the case itself would have been avoided if the document had been so expressed.

The next point to be emphasised by way of conclusion, is the need for financial institutions to recognise the opportunities provided by contractual set-off. Contractual set-off gives the skilled draftsman the opportunity to create a very effective security; there is the flexibility to meet individual circumstances. But the document must be precise and complete. Not only banks but many financial institutions provide a wide range of credit and deposit facilities. Standardised documentation for these facilities could include extended contractual rights of set-off. In reverse the warning to the customer is to be careful to see what the standard documentation proffered by financiers says in relation to set-off.

Finally, there is the need for financiers and particularly banks to recognise the problems that can arise with ad hoc arrangements, particularly with customers in financial difficulties. Careful documentation of arrangements may enable the financier to preserve rights of set-off and hence priority over other secured parties. Here again the reverse warning is for such other secured parties to be fully aware of the granting of rights of set-off which may affect their security.

Footnotes

[1] Broad v. Commissioner of Stamp Duties [1980] 2 NSWLR 40.

[2] Halesowen Presswork & Assemblies Ltd v. Westminster Bank Ltd [1971] 1 QB 1, at p.33-34 per Lord Denning M.R., at p.46 per Buckley L.J., approved on appeal [1972] A.C. 785, at p.802 per Viscount Dilhorne, at p.810 per Lord Cross; Broad v. Commissioner of Stamp Duties, supra n. 1, at p.46.

[3] Supra, n. 1, at p.46.

[4] Supra, n. 1, at p.43.

[5] Supra, n. 1, at p.42.

[6] Supra, n. 1, at p.48.

[7] See Halsbury's Laws of England, Vol.42 paras. 420, 421.

[8] Garnett v. M'Kewan (P.O.) (1872) L.R. 8 Exch. 10; Paget's Law of Banking (1982) Ch.9.

[9] Supra, n. 2, at p.46.

[10] Bradford Old Bank v. Sutcliffe [1918] 2 K.B. 833; Stannard v. National Bank of New Zealand Ltd (1986) 2 NZCLC 99,482, at p.99,487.

[11] Supra, n. 1, at p.48.

[12] Both involve an accounting situation whereby liability is determined by ascertaining the balance of mutual dealings.

[13] Supra, n. 7, para. 421, at n. 2: "Where there was a running account of connected transactions, the common law regarded the balance as the debt so no question of set-off arose: Green v. Farmer 4 Burr, 2214, per Lord Mansfield."

[14] (1968) 88 W.N. (N.S.W.) 498.

[15] Section 31 Bankruptcy Act (UK), Section 86 Bankruptcy Act 1966 (Aust), Section 93 Insolvency Act 1967 (NZ).

[16] Rendall v. Doors and Doors Ltd (in liquidation) [1975] 2 NZLR 191, at p.202 per Chiswell J.

[17] (1985) 16 ATR 862.