BROAD'S CASE AND SET-OFFS

ROBERT TURNER

Senior Legal Officer
National Australia Bank Limited

As a bank lawyer, I suppose more than most I am asked many questions about Securities and particularly in today's society where credit mobility is "the norm", what security can be taken over cash deposits, and just how effective is the security taken. To answer this question I propose to examine a number of areas of the law which relate to the topic in order to try and draw out some possible answers.

In a "cash deposit" security situation there are generally two (or more) accounts, one in debit and one in credit. If the arrangement between banker and customer is documented the effect, hopefully, of the security document is that it will give the bank the ability, on default to apply the proceeds of the account in credit to the account in debit thus repaying the outstanding debt and leave the balance (if any) for the customer assumably, to take elsewhere.

Thus we have, by contractual arrangement, a "combination" of accounts and a contractual set-off of the proceeds.

Outside such contractual arrangements however, a bank already possesses these powers under general law but they are subject to a number of limitations.

First "Combination". This is often confused with bankers "lien" or "set-off", to name but two, although "combination" really has independent character. Combination is more a notional merger of balances in accounts maintained by a customer. In practical terms it is often coupled with "set-off" but is capable of isolation. In its true context combination is the means whereby a banker can ascertain the full extent of the customer's indebtedness to the banker across all accounts.

To some combination is a manifestation of a banker's desire to terminate the banker/customer relationship. This one would assume, only arises where the banker had reason to be dissatisfied with the relationship in the first place; however the ability to "terminate" the relationship in this fashion is not always as easy as it may sound.

It is clear from the cases that only the banker has the right to combine. [1] In that case referred to by Weaver and Craigie in their work "Banker and Customer in Australia" as "a most important authority on the subject of combining accounts and (it) has never been seriously questioned", the Court held that a banker had the ability to combine a customer's accounts, even those at different branches, in order to disclose whether sufficient funds were available to meet a prospective debt (in that case cheques, drawn against one of the accounts). It was argued in that case that the customer does not have the ability, as a general rule, to force the bank to combine, "He (the customer) could not assert that he had a credit balance at another branch which would cover his demand". [2]

In more recent times in the first "Halesowen" case [3] Lord Denning argued that a customer did have a right to call on the banker to combine accounts in the absence of some contrary agreement. He cited the case of Mutton v. Peat [4] in support of this argument. Without going into the facts of that case the Court took the view that the only way in which the indebtedness of the customer to its bankers would be ascertained was by first combining the respective accounts.

The matter is still not totally free from doubt and good argument can and has been put in each direction, as has the proposition that a banker may at its discretion combine some accounts and leave others separate. Whilst some commentators believe this may enable the banker to "have its cake and eat it too", the better view appears to be that the proposition would be subject to contrary agreement, either express or implied.

In any discussion of combination the question of "notice" is always an issue. Does notice, or a reasonable period of notice, have to be given to the customer before accounts are combined? Once again, to answer the question, a discussion of the cases is required but again, no clear resolution can be found.

That there was no legal obligation on the banker to give notice of its intention to combine was made clear by both Bramwell B and Kelly B in Garnett v. McKewan [5] where the case revolved around the question of dishonouring of customers' cheques. Conversely however in Buckingham & Co v. Midland Bank Ltd [6] it was held that the customer was entitled to reasonable notice of the bank's intention to combine. The basis of that decision appears to be that the customer, where his current account is in funds, should not have his current account unilaterally closed by the bank without notice in order to meet a call on an outstanding loan account.

It has been suggested by some writers that the approach adopted by the Court in that case is somewhat inconsistent with other cases in some respects and appears to be related directly to the type of account involved. A brief discussion of the types of accounts which may be the subject of combination is therefore perhaps warranted.

As a general rule, trust accounts would be excluded from the right to combine where the bank is on notice of the trust nature of the account. In Union Bank of Australia Limited v. Murray-Aynsley [7] accounts were combined by the bank having no notice of the trust nature of any of the accounts. It was on appeal that this ability to combine in such circumstances was upheld by the Privy Council. Conversely, in Barclays Bank Ltd v. Quistclose Investments Ltd, [8] the bank knew, or ought to have known, the trust nature of the moneys in the account in question, and was therefore prevented from combining the first account (being in the nature of a trust) with others operated by the customer.

In the case of current accounts, subject to the question of notice discussed above, there does not seem to be any restriction on combination; however, with loan accounts, there is a great deal of case law, and the subject is well documented by other commentators.

Swift J. in W.P. Greenhalgh & Sons v. Union Bank of Manchester[9] said:

> "If a banker agrees with his customer to open two or more accounts he has not in my opinion, without the assent of the customer, any right to move any asset or liabilities from one account to the other; the very basis of his agreement with his customer is that the two accounts should be kept separate."

That is, combination can be excluded by contrary agreement - express or implied - see Garnett v. McKewan above.

More recently in Halesowen, [10] Roskill J. said "The crucial question must always be, 'what was the contract?' and not whether a particular account or accounts bear one title rather than another". If this reasoning is correct, and I believe it is, then any account is capable of combination subject to there being some agreement to the contrary. The question of savings accounts being subject to combination with other accounts maintained by "Trading Banks" in Australia would of course, so far as the established banks are concerned generally not apply, as the "savings" function is handled by the "Savings Bank" subsidiary. The matter could arise however with some new banking entrants and the State banks which conduct both savings and current accounts through the same entity.

An interesting question which I don't propose to follow here is whether any right of combination exists for some of our building societies (which appear to be "banks" all but in name) and perhaps more fundamental still "who is a banker" and "what is banking business"?

It seems to me from all the cases and commentaries that the right of combination can arise from any dealing between the banker and customer which is in the ordinary course of banking business.

> "No one would say that a bank might set-off against his customer's account a debt due to him from his customer in another capacity, a private debt for example or a debt due to him as carrying on some distinct business." [11]

The only restriction on this being that there is no agreement between the parties to keep the respective accounts or debts separate.

From the above, irrespective of the nature of specific security which may have been taken and whether or not that security is a charge capable of registration and dutiable, it can be seen that fundamental rights exist under the general law as to relationship between the banker and his customer. Can he combine trust accounts? Does he have to give notice? Whilst I could use the old catch phrase "it depends on the circumstances" more importantly it seems it depends on contrary agreement, expressed or implied.

Combination however, is but one aspect of a very large topic which includes "set-off" to which I now want to turn my attention. Set-off is often seen as one and the same as combination but I have so far sought to distinguish the two.

In his paper "The Law of Set-Off in New York" [12] Peter M. Mortimer states:

> "The doctrine of set off of mutual obligations has its basis in ancient history. In Roman law, it was called compensation and referred to the cancellation of cross-demands in a proceeding before a judge. The right of compensation was available only in a limited number of judicial actions and it developed gradually. The oldest surviving legal commentary of significance on compensation appears in The Institutes of Gaius, written about 161 AD. Gaius notes that in some cases the judge may take into account counter-obligations arising in the same transaction and that in a special case of a banker suing his customer, the banker must balance accounts and claim only the net amount owing."

Roman law it would seem, as with many other aspects of Roman life (for example, their road building) was very clear cut and practical.

Today the law of set-off, both as has been derived through the common law, which tended to be restrictive, and the doctrine derived through equity cases, have in common a number of important elements, namely, the right (to set-off) applies only to unrestricted deposits or those otherwise unencumbered, and the obligation, against which the deposits are set-off, must be matured and capable of being enforced.

Whilst in the English case of Greene v. Farmer [13] Lord Mansfield noted (as cited by Peter Mortimer):

> "Natural equity says, that cross demands should compensate each other, by deducting the less sum from the greater; and that the difference is the only sum which can be justly due. But, positive law, for the sale of the forms of proceeding and convenience of trial, has said that each must sue and recover separately in separate actions."

The position now, thanks in part to section 86 of the Bankruptcy Act 1966 (Commonwealth) and to section 438(2) of the Companies (Victoria) Code would appear to be that when there have been mutual dealings between a bankrupt and his creditor prior to bankruptcy, those mutual dealings may be set-off for the purpose of proving either against, or in favour of the estate, as the case may be.

Here again, some would argue that the law favours the banker, who, rather than pay his debt into the estate and then seek to recover from the estate with all others, is entitled to full recovery by set-off. The courts in Australia however, have not permitted this combination and set-off in all situations, particularly where the effect may constitute a "voidable preference" in favour of the bank. Be that as it may, as is noted by A. Herzberg [14] in his excellent paper on combination:

> "The statutory set-off in bankruptcy only comes into operation once the debtor is bankrupt. Combination, on the other hand, can only occur prior to a customer's bankruptcy or liquidation. The set-off and combination are in this sense mutually exclusive."

In the Halesowen case [15] the House of Lords was of the view that statutory set-off applied even though it had been agreed, between the parties, that set-off be excluded for a period. Lord Cross held [16] that the agreement subsisted until the banker-customer relationship came to an end. Thereafter the bank had the right to combine accounts.

Should this aspect of the case be followed in Australia bankers would no doubt be comforted in agreeing to exclude a section 86 provision in their documents on the basis that the Court would probably grant them the right to set-off in any event.

So far as "bankers liens" are concerned there is often confusion between "combination", "set-off" and "lien"; however the succinct statement contained in Halsbury (4th ed) says at paragraph 78:

> "The general lien of bankers is part of the law merchant as judicially recognised; it connotes the right of a banker to retain the subject matter of the lien until an indebtedness of the customer is paid or discharged. It attaches to all securities deposited with the banker as banker by a customer, or by a third party on a customer's account, to instruments paid in for collection, and to money held to the account of a customer, unless there is an express or implied contract between the banker and the customer which is

> inconsistent with the lien. In the case of money, the banker's right is often a right of set-off; it arises only in relation to the customer's money and does not apply to money paid in under a mistake of fact."

Bankers' liens therefore, whilst often used generically with combination and set-off are generally outside the scope of this topic, probably give the banker the right to sell the relevant security the subject of the lien after reasonable notice to the customer. The lien however does have a number of shortcomings:

(a) it does not attach to securities which the bank knows to have been subsequently assigned by the customer to a third party to the full extent of the customer's beneficial interest in the securities if the purpose of relying on the lien is to reimburse the bank in respect of advances made by it to the customer after notice of the assignment;

(b) it is displaced by contrary agreement between the parties;

(c) it does not attach to securities known by the bank not to be the property of the customer at the date when they are first received by the bank;

(d) it does not attach to securities or other property given to the bank for safe custody;

(e) it does not attach to securities deposited by the customer which the bank knows to be subject to a trust in favour of a third party.

To that end I don't propose to deal further with liens as such but will concentrate on rights over cash.

I want to now look briefly at some of the interests which may, and in some cases probably are, created by our contractual arrangements similar in effect to those discussed in Broad's case, but looking perhaps at different aspects and in the light of more recent thinking.

One wonders whether quite a different conclusion may have been reached in Broad's case today having regard to the House of Lords decision in the Swiss Bank Corp case [17] where Buckley L.J. stated:

> "If the debtor undertakes to segregate a particular fund or asset and to pay the debt out of that fund or asset, the inference may be drawn, in the absence of any contrary intention, that the party's intention is that the creditor should have a propriety interest in the segregated fund or asset as will enable him to realise out of it in the amount owed to him by the debtor."

The rationale to be drawn from this statement is that it is possible that parties can create a charge without meaning to or realising such a charge has been created.

On the other hand one must look at the question of such a charge in the light of other cases to decide whether the bank needs a "charge" over the deposit in the first place and indeed whether it can in fact take such a charge. In applying the dictum in the Halesowen case [18] at page 810 "a debtor cannot sensibly be said to have a lien on his own indebtedness to his creditor", Mr Justice Lee found in Broad's case that:

> "The very fact that the 'deposit' means no more than an indebtedness of the bank to the plaintiff ... makes it impossible, in my view, for it to be held that the instrument is a mortgage or charge, on the simple footing that there can be no mortgage or charge in favour of one's self of one's own indebtedness to another."

Of course this position is quite different where a deposit is held by another institution.

In this paper to date I have been attempting to concentrate on both the effect of the general law, and more laterally, the albeit involuntary result of some contractual arrangements, which affect the deposit. I have purposely avoided the specific issue in Broad's case of assignment of the deposit from the customer to the bank. This question raises a number of issues which I'll refer to as "intentional consequences" and look at shortly.

The other aspect of the discussion to date is the presumption that the customer is solvent. Any of the above "remedies" are, subject to compliance with the applicable rules, quite effective in relation to a solvent customer.

I now want to turn my attention to the question of the insolvent customer; which I suppose is the time most bankers begin to think about their security at all.

In his paper on the topic "Choses in Action as Securities for Banker's Advances" delivered to the seminar of this Association in Melbourne and Sydney last November, David Crawford of Peat Marwick Mitchell & Co said:

> "It will not surprise you that my experience has been that bankers are most anxious to terminate the banker/customer relationship once the customer is declared bankrupt or is wound up.
>
> ...
>
> The appointment of a liquidator to a company is usually outside the control of the banker (this is because the banker usually has some form of security which he utilises to protect his position). In the case of provisional liquidation, the banker would typically have no notice of the appointment until he received a telephone call from the

> provisional liquidator requesting him to freeze the accounts. The bank may therefore be in a less than ideal situation with security documentation half completed and debentures not registered. A large number of cheques may be unpresented while other cheques may have been debited on bank statements but not yet cleared at the company's local branch. This could be true in respect of transactions between various bank accounts run by the company including trust accounts, special purpose accounts and general accounts, and particularly where those bank accounts are at different branches, e.g. Melbourne and Sydney."

How very true.

In the event that our security documents are not executed and registered (if appropriate), how is the banker assisted by either the general law or statute? So far as combination is concerned, as mentioned above, that remedy is not available after the appointment of a liquidator. In such event, the banker's prime remedy would appear to be the statutory right of set-off available through section 86 of the Bankruptcy Act and by section 438(2) of the Companies (Victoria) Code.

Difficulties however, may present themselves from time to time which render the right of set-off not such a clear-cut remedy as some bankers may hope:

(1) there must be mutual credits, debits or other dealings;

(2) at what date is the set-off to be applied;

(3) because of the knowledge and information bankers usually have of their customers affairs there may well be a question of a preference.

In respect of the first matter this can generally be well established. As to the second, in the past as there was no correlation in corporate law to the "act of bankruptcy", set-off could not be effected in respect of credit given to a person after the party seeking the right of set-off had notice of an available act of bankruptcy committed by the other, but in respect of corporate law "what was an available act of bankruptcy?". The Court in Law v. James [19] held that such an act was "any act or omission of the company which would found a petition to wind the company up on the grounds that the company was unable to pay its debts." Any amount lent subsequently by the bank to the customer had to be claimed in the liquidation.

As to the question of preference the courts have not been reluctant to determine against the banks in appropriate cases. [20] On this question it is also worth noting that if combination (before liquidation) is avoided as preferential no set-off is available under section 86. [21]

Turning to the question of registration, on the assumption a valid charge can be granted by the customer, is registration (in the case of a corporate borrower at least) possible under section 200(1) of the Companies (Victoria) Code?

Some commentators have argued that a charge over a current account or an account capable of fluctuation is a floating charge (for the funds can rise and fall) and as such does require registration under section 200(1)(a) of the Code.

This argument is based on the definition of "book debt" contained in section 200(4) of the Code which defines it as a debt due or to become due at some future time on account of or in connection with a profession, trade or business and includes future debt.

In his book titled "Company Charges" Mr W.J. Gough argues that book debts essentially arise from normal trading and that the investment of a company's surplus money in a deposit account, although represented by debts, should not be regarded as book debts. In support of his case at page 290 he cites a New Zealand decision, Watson v. Parapara Coal Co. Ltd. [22] Notwithstanding this case and Mr Gough's arguments, I tend to side with other commentators in suggesting that it is probably a wise precaution to register anyway. As an interesting side note, I understand some English banks at least treat contracts of set-off as creating charges and seek to register the contract under the English equivalent of section 200(1)(f) as a charge on the book debts of the depositor.

To avoid questions of charges and securities altogether it has been argued by some that the more latterly developed device known as the "flawed asset" arrangement achieves the same, or at least equivalent results, without the need for any registration. The concept is that access to the deposit by the customer is postponed until all the stipulated financial accommodation provided by the bank is repaid in full.

Whilst this scheme appears to have had some merit there seems to be one significant weakness in the arrangement, although I'm not aware of it having been tested. The weakness is, that on liquidation or bankruptcy of the customer, the loan presumably has not been repaid (at least in full) and the bank cannot release the deposit. If this were to be the case then the liquidator could never finish his liquidation and the deposit would remain in the bank's books indefinitely. I have substantial doubt that a Court would permit that situation to continue for long. In the event that the Court did order the deposit repaid there may be room for set-off to be applied, however, this would depend on the facts. To my mind the better position is to attempt to take a charge and to register it and thus achieve a reasonable security position vis a vis other creditors.

The final point I want to discuss arising out of Broad's case, is the subject of assignment.

In their paper "The Legal Nature of a Charge on a Bank Balance" given at the seminar of this Association in Melbourne and Sydney last November, Peter Fox and Justin Smith have argued, and I now believe quite convincingly, that it is possible for the depositor to assign to the bank his right in the deposit until repayment of his financial commitments to the bank.

In Broad's [23] case Mr Justice Lee said:

> "But no question of an assignment to the bank of the chose in action constituted by the loan, or of the 'fund' made up by the $4,000, can arise in the present case - the chose in action constituted by the loan is the plaintiff's right, as creditor, to enforce the loan in accordance with its terms; and that right cannot be assigned to the bank, the debtor. Any document purporting to achieve such an assignment could only operate as a release of the debt, or a covenant not to sue."

The statement that the "assignment could only operate to release the debt" has been taken to mean that the debt would be released by operation of the doctrine of merger. Put simply, this doctrine means that a contract may be discharged where the rights and liabilities under it become vested, by assignment or otherwise, in the same person - IN THE SAME RIGHT.

In the case of a charge or an assignment, they argue the contract cannot be discharged as the rights, although vesting in the same person, do not vest in the same right. For example when a chose in action is assigned by way of security, the debt is vested in the assignee, not as creditor but as chargee. The assignor retains his right of redemption and can require, and enforce, re-assignment of the debt. In the case of an equitable assignment, the assignee is not entitled to sue in his own name but must make the assignor a party in any action to recover the debt.

In this paper I have sought to weave a relationship between several sometimes conflicting areas of the law as they relate to our topic today. Hopefully some of the issues covered will stimulate delegates' thinking and in the future some clarity and certainty can be reached in this very important area of the law.

To conclude in the words of Mr Justice Plush in "The Post Master General v. Slot":

> "It is quite wrong to suppose, as many people do, that the law perceives some mystical virtue of betting on credit which places it on a higher moral plane than betting on a 'cash down' basis. Indeed as the good Mr Haddock has often observed, the contrary might well be asserted, for he who bets in cash bets with money he actually possesses, while he who bets on credit, bets with money which he may not possess, and if he loses, will have to acquire by fair means or foul." [24]

Bankers always like to bet on the "cash down" basis and probably the average man in the street would find it strange to think that the law places so many apparent obstacles in the way of the banker to secure himself against such a common and obvious asset.

Footnotes

[1] Garnett v. McKewan (1872) L.R. 8 Ex 10.
[2] Garnett v. McKewan (1872) L.R. 8 Ex 10. per Bramwell B at 15.
[3] Halesowen Presswork & Assemblies Ltd v. Westminster Bank Ltd [1971] 1 Q.B. 1 at 34.
[4] [1900] 2 Ch 79 (C.A.).
[5] (1872) L.R. 8 Ex 10.
[6] (1895) 12 T.L.R. 70.
[7] (1898) A.C. 693 (P.C.).
[8] (1968) 3 All E.R. 651.
[9] [1924] 2 K.B. 153 at 164.
[10] [1971] 1 Q.B. 1 at 21.
[11] (1872) L.R. 8 Ex 10 at 14 per Piggott B.
[12] International Financial Law Review, May 1983 at 24.
[13] 98 Eng Rep 154 at 157 (K.B. 1768).
[14] 1982 Australian Business Law Review at 79.
[15] (1972) A.C. 785.
[16] (1972) A.C. 785 at 811.
[17] (1982) A.C. 584 at 589.
[18] (1972) A.C. 785.
[19] [1972] 2 NSWLR 573.
[20] Re Shaw: Ex parte Andrew v. Australia and New Zealand Banking Group Limited (1977) 31 F.L.R. 118.
[21] Re Armour: Ex parte Official Receiver v. Commonwealth Trading Bank of Australia (1956) 18 A.B.C. 69.
[22] Watson v. Parapara Coal Co. Ltd (1915) 17 GLR 791 (N.Z.).
[23] [1980] 2 NSWLR 40 at 46.
[24] See "Uncommon Law" by A.P. Herbert.