PREFERENCES - RUNNING ACCOUNTS CHARGES AND SET-OFF - THE IMPLICATIONS OF THE CHARGE CARD SERVICES CASE

PROFESSOR ROBERT BAXT

Faculty of Law
Monash University, Melbourne

What I am going to talk about, as I have indicated in my outline, is really a separate issue but one that I believe does tie into this whole question of running accounts. My topic is the extent to which banks in particular, (although the case that is going to be the centre of my comments, the Charge Card Services (Re Charge Card Services Ltd [1986] 3 All ER 289) case did not involve a bank) where it has two sets of accounts with a particular customer, should or can take a charge in respect of an account in credit and what effect the failure of taking the charge might be in relation to its ability to set-off its credit against liabilities. Does the bank merely take account of the amounts in debit and in credit in the two accounts in order to finish up on the positive side.

The Charge Card Services case which was reported late last year is the judgment of a single judge in the English High Court and therefore we have to wait I think to see whether (a) it will be taken on appeal or (b) whether there will be a case going to a higher court dealing with some of these issues. There are two basic questions that I would like to deal with, in relation to this case. The first is the question of whether in fact it is necessary or it is possible for the bank in that particular situation to take a charge over the amount in credit? What happens if it does not? Secondly I wish to look briefly at the question of set-off in the context of the contractual arrangements that are entered into between the creditor (the bank) and the customer (in this case the charge company) which might have the effect of avoiding the operation of the provisions of the Bankruptcy Code or the Companies Act.

The first question was adverted to but not specifically in the Halesowen case, which is a case that went to the House of Lords in England. A customer was in debit to the bank, which decided to freeze the particular account and to open up another account in relation to the customer which was going to operate for a period of time of four months. There was language used in the "contract" to the effect that the customer would try to sort out

things in that period of four months. The company went into liquidation in this period. The question was whether the bank could keep the moneys that were in credit in the new account or off-set it against the amount which was owing on the frozen account; or could the liquidator recover the money from the bank. The bank lost in the Court of Appeal.

There was a judgment two to one in favour of the liquidator. Lord Justice Buckley, although he read the contract in the same way as his brothers on the Court of Appeal including Lord Denning, dissented in the final result.

When the case went on appeal to the House of Lords, they confirmed the decision of Lord Justice Buckley in relation to the question of set-off, but also interpreted contract in a different way and said that the bank and the customer had entered into a particular arrangement which allowed the bank in effect to keep the benefit of the the amount in the No 2 account in that particular context.

What I want to concentrate on in relation to that case is however not that particular aspect, although that is certainly of interest and of relevance, but the question of whether in fact the bank could take a lien or charge over the cheques that had been paid into the new account just days before the company went into liquidation, and whether it was possible for this particular lien or charge to be set aside by the liquidator because registration of the charge had not been effected.

Let me turn to comments that were made in the British Eagle case which you have heard a little bit about from Maurice Cashmere yesterday. The British Eagle case involved a rather complex arrangement between the various airline transport corporations that belonged to IATA whereby they agreed to set-off amounts that were owing to each as a result of services that were carried out by one company for another company. This was to be achieved by a clearing house arrangement that had been set up by IATA. It turned out that the British Eagle company had rendered services to Air France which in effect put it in credit, as far as Air France was concerned, by some thousands of pounds. When British Eagle was liquidated the question arose as to whether the liquidator could recover this money from Air France without going through the clearing house procedures. It was held it could.

What I would like to deal with is the question of the charge issue that was raised in this particular case in trying to defeat the claim of the liquidator. It was suggested that what in effect had taken place was that a charge had been created in favour of each of the companies that were in credit. Every time there were services rendered by one company for another company we had a situation where the company should take a charge in order to secure amounts that were due.

The only member of the House of Lords to deal with this particular issue was Lord Cross. He noted:

> "It is true that if Air France are right the 'clearing house' creditors will be treated as though they were creditors with valid charges on some of the book debts of British Eagle (the plaintiff company). But the parties to the 'clearing house' arrangements did not intend to give one another charges on some of each other's future book debts. The documents were not drawn so as to create charges but simply so as to set up by simple contract a method of settling each other's mutual indebtedness at monthly intervals. Moreover if the documents had purported to create such charges, the charges ... would have been unenforceable against the liquidator for want of registration under section 95 [our section 205] of the Companies Act 1948. The 'clearing house' creditors are clearly not secured creditors. They are claiming nevertheless that they ought not to be treated in the liquidation as ordinary unsecured creditors but that they have achieved by the medium of the 'clearing house' agreement a position analogous to that of secured creditors without the need for creation and registration of charges on the book debts in question."

It is this comment which has created interest and debate. I understand in particular this debate has gone on in England and perhaps Richard Youard might say something about this in relation to some of the documentation that has been entered into by banks and others in relation to this kind of issue. The matter came up for specific consideration in this Charge Card case.

One of the reasons why the case is so interesting for me is because Professor Roy Goode in his work "Legal Problems of Credit and Security" changed his views as to whether a bank could in this particular context take a charge over the amount in credit. This is what he says at page 186 of this particular work:

> "A customer's credit balance with his bank is, of course, an asset which he can charge to a third party. But can he charge it to the bank itself for example to secure a contingent liability? Such charges are quite commonly taken to overcome limitations on the bank's right of set-off, and many lawyers see no obstacle to this. Yet there are others, whose opinions command equal respect, who stoutly maintain that a charge over the customer's credit balance in favour of the bank holding the balance is inherently impossible, for the effect of the charge is to make the bank its own creditor to the extent of the obligation secured."

It is this particular issue which was dealt with in part by Lord Justice Buckley in the Halesowen case and by Millett J in the Charge Card case.

In the Charge Card case you had a situation where the liquidator asked the court to determine certain issues which really had not arisen for direct dispute. The court was asked for opinions on

certain issues and Millett J threw up some interesting observations on how credit charge operations work and whether the company that operates the credit charge operations is the only person that can sue in relation to the services that are rendered to customers.

We will not deal with those issues. I will deal with the issue of whether the company which was the company had received the benefit of the amounts due to the credit card company could in effect retain the benefit under the contractual arrangements it has entered into and off-set them as against the amounts that may have been due to the credit charge company. Could it or should it in the context of that particular retention right have secured its rights by taking a charge? The liquidator argued that a charge had been given by the credit charge card company to the company and as it had not registered the charge, it was therefore void under the equivalent of s.205 of the Companies Code.

Millett J in this case stated that the only asset which the company could charge was a right to sue - a chose in action i.e. the benefit C Limited had received under the factoring arrangement. Under the terms of the arrangement that had been entered into, C Limited already could retain amounts under the separate arrangement that it had with the company. The liquidator suggested that this right of retention was in fact a charge (in the form of a security) which had not been registered.

Whilst counsel for the liquidator conceded that the relevant debt could not be assigned in whole or in part to the debtor, nor could it be made the subject of a legal or equitable mortgage (because this required a conveyance or assignment by way of security) that nevertheless an equitable charge did not need to involve a conveyance or an assignment of property.

In dealing with this particular issue Millett J turned to some older authority to help him deny the particular arguments put forward by the liquidator in this case. The two cases that are referred to in his judgment are Palmer v. Carey [1926] AC 703 (especially at pages 706-707) and National Provincial and Union Bank of England v. Charnley [1924] 1 K.B. 43 (especially at pages 449-450).

Millett J discussed extracts from those cases and in particular he emphasised the argument that you could not in effect create a charge in such circumstances because what you would have (as a result) would be a person who would be in a position of suing himself if the charge had to be relied on. He also relied heavily on statements made by Buckley LJ in the Halesowen case. Let me read you what Buckley LJ had to say in that case which is particularly relevant to the situation of the banker and customer, and which Millett J regarded as being relevant in the case before him.

> "Where the relationship of the banker and customer is a single relationship ... albeit embodied in a number of

> accounts, the situation is not, in my judgment, a situation of lien at all. A lien postulates property of the debtor in the possession or under the control of the creditor. 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." (At page 487-488.)

Millett J then added:

> "The essence of an equitable charge is that, without any conveyance or assignment to the chargee, specific property of the chargor is expressly or constructively appropriated to or made answerable for payment of a debt and the chargee is given the right to resort to the property for the purpose of having it realised and applied in or towards payment of the debt. The availability of equitable remedies has the effect of giving the chargee a proprietary interest by way of security in the property charged. It is true therefore that no conveyance or assignment is involved in the creation of an equitable charge, but in my judgment the benefit of a debt can no more be appropriated or made available to the debtor than it can be assigned or conveyed to him. The objection to a charge in these circumstances is not to the process by which it is created but to the result. A debt is a chose in action, it is the right to sue the debtor. This can be assigned or made available to a third party but not to the debtor, who cannot sue himself. Once any assignment or appropriation to the debtor becomes unconditional the debt is wholly or partially released. The debtor cannot and does not need to resort to the creditor's claim against him in order to obtain the benefit of the security. His own liability to the creditor was automatically discharged or reduced." ([1986] 3 All ER at p 309.)

Millett J also relied on Buckley LJ for arguments in relation to the existence of a lien and the way in which Buckley LJ dismissed those arguments in that particular context.

In this case and in the Halesowen case what the court in effect says is that if you have a separate contractual arrangement between the parties which gives them the right to account to each other for amounts in the two accounts, then you have a running arrangement between them so that you could debit amounts in one account against credits in another, and retain the balance (if any).

If in fact that analysis is correct and no charge can be created over the credit balance then as I understand it there is a good deal of rethinking that has to be done in London in relation to a number of transactions that are entered into by banks. It has been suggested for example that one way around it is to ensure

that a wholly owned subsidiary company is brought into the picture so that a charge can be given by the debtor to a wholly owned subsidiary of the bank. This will however create problems if you try to rely on set-off, especially under statute because you have got to show that the arrangements are mutual as between the parties and not between independent entities.

We know as we heard from Mr Justice Peter Young yesterday that our courts are reluctant to treat companies in a group as though they are one entity. There are some dicta in English cases which suggest that the English courts are prepared to lift the corporate veil and look behind the arrangements between the parties to treat groups of companies as one in certain circumstances. There is a particularly interesting case in England, the DHN case, (DHN Food Distributors v. London Tower of Hamlets) which I suggest is worth study. But contrast to that the very strict interpretation given to this whole question by our own High court in Industrial Equity Ltd v. Blackburn.

Finally Mr Chairman, I should mention the question of set-off. The court in this particular case, the Charge Card case, held that in fact set-off was possible in this particular context. There is a useful analysis of the operation of s.31 by Millett J in this case. He goes through a number of cases and has suggested that banks and other creditors do have the right to use set-off in circumstances such as those arising in the Charge Card case.

Can a person contract out of the operation of the Companies Code or the Bankruptcy Code with respect to set-off? It is relatively clear from the English cases that you cannot. There are comments in both Halesowen and in Chard Card that they would not allow the relevant sections to be contracted out because this would be against public policy. The issue was also dealt with in the British Eagle case. Mr Justice King in Geraghty's case, without dealing with the statutory provisions, said that it was clear that the bank and the customer could enter into a separate arrangement to deal with their particular liabilities in these situations. He did not turn to deal with the question of what would happen if liquidation occurred and you relied on the equivalent of s.86 of the Bankruptcy legislation.