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Recent Developments in Banking and Insolvency Law

Presented by

The Rt. Hon Peter Blanchard

A Judge of the New Zealand Court of Appeal

Paribas would not have been able to raise the fraud exception, because they would be estopped from disputing Santander's authority to discount." However, on the facts, Santander was not entitled to claim reimbursement. The appeal was dismissed.

Smith and anor v Lloyds TSB Group PLC

Harvey Jones Ltd v Woolwich PLC

[2000] 3 WLR 1725

The English Court of Appeal considered the meaning of the term "avoided" in s64 of the Bills of Exchange Act 1882. Section 64(1) provides that:

> Where a bill or acceptance is materially altered without the assent of all parties liable on the bill, the bill is avoided except as against a party who has himself made, authorised, or assented to the alteration, and subsequent indorsers. (see s9 Bills of Exchange Act 1909 in Australia and s64 Bills of Exchange Act 1908 in New Zealand)

The claimants in each case were respectively the owners of a non-negotiable cheque and the payee of a banker's draft, which were stolen from the claimants and fraudulently and materially altered by the deletion of the original payer's name and the insertion of the name of a third party. The altered instruments were presented to the collecting bank, paid into the third party's account and cleared.

In the first action, the claimants sued the collecting bank in conversion for the face value of the cheque. In the second action, the claimants sued the paying bank in conversion for the face value of the banker's draft.

The banks conceded that they had converted the pieces of paper, but denied liability for the face value of the instruments on the grounds that, under s64 of the Bills of Exchange Act 1882, the materially altered cheque or draft was avoided and therefore worthless in their hands.

On the first action, the trial Judge gave judgment for the collecting bank. In the second action, however, judgment was given for the claimants.

The Court of Appeal held that the effect of the word "avoided" in s64(1) is that the materially altered cheque or draft is, subject to the qualifications in the section, a worthless piece of paper. It is no longer a cheque and no action can be brought upon it as a cheque. No party can bring an action for damages in conversion for its face value because it no longer represents a chose in action for that amount.

In the case of a cheque, Pill LJ held that a customer of the paying bank is protected because the bank, which bears the risk, cannot debit the customer's account. In the case of a banker's draft, the customer's account is debited when the draft is issued to the customer, who has the benefit of a bill drawn by the bank itself. However, once the customer has the draft, the customer assumes the relevant risk, just as if the customer had been given bank notes that are subsequently stolen.

The Court held that it does not follow from the fact that the paying bank will generally issue a replacement draft, if the invalidity is discovered before the collecting

bank credits the wrong account, that the materially altered draft is valid. The paying bank will have suffered no loss and may issue a replacement draft as a matter of good business practice, or possibly contractual obligation. However, the likelihood of such action by the bank does not render valid what s64 renders invalid.

Further, merely by presenting the invalid cheque, the collecting bank was not asserting its validity. It was not estopped from denying that the cheque had value.

Both banks were therefore successful in defending the claims.

Portman Building Society v Dusangh

[2000] 2 All ER (Comm) 221

The claimant building society granted a mortgage to Dusangh secured over his house. Dusangh was aged 72 and retired. He was illiterate and spoke English only poorly. The mortgage was a 25-year repayment mortgage and the sum advanced was £33,750, approximately 75% of the property's value.

Dusangh's son, who received the bulk of the money for use in purchasing a supermarket, guaranteed the mortgage. The same solicitor acted for Dusangh, his son and the building society. The supermarket was not a success and the son fell behind on the mortgage repayments. He was declared bankrupt and his guarantee proved worthless. The building society successfully brought proceedings for a declaration of the validity of the mortgage and an order for possession of Dusangh's property. Dusangh appealed, contending that he was entitled to set aside the building society's charge as an unconscionable bargain.

The Court of Appeal held that it was not manifestly disadvantageous to Dusangh that he should raise money by way of mortgage for the benefit of his son. He did not have any pre-existing indebtedness to the society. It was not in possession of any material information which was unavailable to Dusangh's solicitor. Nor was the transaction one that no competent solicitor could have advised Dusangh to enter and one, therefore, in which the solicitor should have refused to act (as in *Credit Lyonnais Bank Nederland v Burch* [1997] 1 All ER 144).

Although Dusangh, being elderly, illiterate and on a low income, was the modern equivalent of 'poor and ignorant', as explained in *Burch*, and the transaction was an improvident one, dependent on the son's success, the Court held that building societies should not be expected to police transactions of this nature to ensure that parents were wise in seeking to assist their children.

The bargain as a whole was not considered overreaching and oppressive. None of the essential touchstones of unconscionability were found on the facts. Dusangh was not at a serious disadvantage to the building society, his situation was not exploited by the society and the society had not acted in a morally reprehensible manner.

Ward LJ described the transaction in the following manner (at p236):

> The family wanted to raise money: the building society was prepared to lend it. One shakes one's head, but with sadness and with incredulity at

> the folly of it all, alas not with moral outrage. I am afraid the moral conscience of the court has not been shocked. That is the end of the matter.

Just because hindsight suggested that it was commercially unwise for the building society to put its trust in Dusangh and his son, this was not to say that it was morally culpable for it to do so. The appeal was dismissed.

Skipton Building Society v Stott

[2000] 2 All ER 779

This decision of the English Court of Appeal concerned what rights a lender of money secured by a property mortgage has against the guarantor of the loan, when the lender has exercised the right to sell the property as mortgagee, but has failed to obtain its true market value.

Stott was a director of a company that acquired a leasehold interest in a property with a mortgage obtained from the Skipton Building Society. Stott and his fellow director guaranteed the mortgage. The company ran into financial difficulties and receivers were appointed by the Building Society. As the business could not be sold as a going concern, it was closed.

The occupiers of adjoining property made an offer for the leasehold, which was eventually accepted after the Building Society sought advice from an independent chartered surveyor. The offer was less than the balance of the mortgage debt guaranteed by Stott and the Building Society claimed the shortfall.

Stott contended that the Society had not complied with an implied term of the contract of guarantee, reflecting its duty under the Building Societies Act 1986 to take reasonable care to ensure that the price at which the land was sold was the best price reasonably obtainable.

The Judge found that because the availability of the lease had not been advertised, the Society had lost the chance of obtaining a better price. The Judge valued the loss of that chance at £2,500, holding that the Society's breach was equivalent to a breach of a warranty, rather than a breach of condition.

Stott appealed on the ground that the true effect of the Society's breach was to release him from further liability. His counsel cited, inter alia, a statement by the Court of Exchequer in *Watts v Shuttleworth* (1860) 5 H & N 235, 157 ER 1171 that:

> In equity upon a contract of suretyship, if the person guaranteed does any act injurious to the surety, or inconsistent with his rights, or if he omits to do any act which his duty enjoins him to do, and this omission proves injurious to the surety, the surety will be discharged.

The Court of Appeal, however, held that a creditor's failure to obtain the proper value of a security being sold merely reduces pro tanto the amount for which the guarantor is liable. It does not release the guarantor from all further liability. The creditor's

breach was not a repudiation of the contract of guarantee. It was a breach of warranty only.

The Court found that the Judge below had been wrong to allow as compensation only a figure representing the value to Stott of the lost chance to obtain a better price. The correct approach was instead to compare the amount recovered by the creditor with the property's true market value. Such a valuation is merely an issue of historic fact, to be established by whichever party has the burden of proof. There was no question of a future uncertain event that might require assessing the value of the loss of a chance.

Because the market value of the property was significantly higher than the amount secured, the Building Society had to give credit for a higher amount. There was no longer a shortfall. The appeal was allowed.

Crantrave Ltd v Lloyds Bank PLC

[2000] 3 WLR 877

The English Court of Appeal considered when a bank may, without authorisation or ratification by its customer, make payment to the customer's creditors out of the customer's account.

On 28 April 1993 the plaintiff company was ordered to pay £150,000. On 7 May 1993 a garnishee order nisi was secured by the judgment creditors upon the company's funds with the defendant bank.

On 19 May 1993 the bank paid to solicitors acting for the judgment creditors the sum of £13,497. But later, as the garnishee order nisi was not made absolute, the proceedings founded on it were stayed.

In August 1993 the company was wound up. The liquidator brought an action against the bank claiming that it had wrongfully and without authority debited the company's account. The liquidator sought repayment by the bank of the amount paid to the judgment creditors. In its defence the bank argued that the company suffered no loss, as the payment merely discharged an existing debt. It argued that there is an equitable doctrine that a person who pays the debts of another without authority is allowed the benefit of such payment. The District Judge gave summary judgment against the bank.

The English Court of Appeal held that, where a payment to a third party is made on another's behalf without authorisation or ratification, it is not enough, to establish an equity in favour of the payer, to show that the payment enured to the benefit of the person on whose behalf it was made. Pill LJ laid down the following principle (at p883):

> It is a startling proposition that bankers can pay sums to a third party out of a customer's account because they believe the customer to be indebted to that third party. I see no difference in principle between a judgment debt and other perceived debts. As against a customer, a contrary principle would place the bank in a position to act as debt

> collector for creditors of the customer. It would be for a customer who contested a creditor's claim then to seek relief. The bank could decide in what priority the claims of creditors were to be met out of the sums in the account, without the customer having recourse against the bank. A bankruptcy or liquidation may occur shortly after a payment, as in this case, with possible effects on the rights of creditors generally.
>
> There will be circumstances in which a court may intervene to prevent unjust enrichment either by the customer in having his money from the bank as well as having the claim of his creditor met, or by the creditor who has double payment of the debt. The onus is in my judgment on the bank to establish the unjust enrichment on the evidence.

The Court held that the payment could not of itself discharge the company's legal liability to the judgment creditors. There was no ratification or authorisation of the payment. There was no evidence that the company had been unjustly enriched. The bank therefore had no defence. The appeal was dismissed.

Covington Railways Ltd v Uni-Accomodation Ltd

[2001] 1 NZLR 272 (CA)

The New Zealand Court of Appeal considered whether a performance guarantee could constitute a "payment" or a "charge" for the purposes of satisfying a statutory demand. The New Zealand Companies Act 1993 requires that the demand must:

> [r]equire the company to pay the debt, or enter into a compromise under Part XIV of this Act, or otherwise compound with the creditor, *or give a charge over its property to secure payment of the debt,* to the reasonable satisfaction of the creditor, within 15 working days of the date of service, or such longer period as the Court may order. (cf. s459E Corporation Law)

The appellant, Covington, and the respondent, UAL, a company owned by the University of Auckland, entered into contractual obligations relating to the development by Covington of 227 residential units in a former railway station building. UAL agreed to take long-term leases of certain accommodation units and arrange occupation by students, staff and other persons approved by the University.

Covington covenanted with UAL that during a two year guarantee period it would meet any shortfall in the revenues received by UAL and would also meet certain outgoings in respect of those units. Covington stopped paying UAL's monthly invoices for revenue shortfalls and outgoings in October 1999. In February 2000, UAL served two statutory demands on Covington for sums totalling $421,536. In May, a third statutory demand was made for $289,086. Covington did not comply with any of these demands and UAL applied to the High Court for the liquidation of Covington.

In the High Court it was held that there were insufficient grounds supporting the appellant's claimed set-off. The Court held that the appellant had seven days from the judgment date of 31 August 2000 to pay a revised total of $539,256, which was considered indisputable.

The main issue before the Court of Appeal was the relevance of a performance guarantee between the Hong Kong and Shanghai Banking Corporation Ltd ("the Bank") and UAL. Covington had contracted with UAL that, as security for its obligations under its covenants relating to outgoings and revenue shortfalls and default interest, it would:

1. Execute a bond for $1 million (which it had done); and
2. Procure certain performance guarantees in an agreed form.

Covington obtained a performance guarantee in the amount of $500,000 by depositing that amount with the Bank, executing a charge over all its assets, including the deposit account, and requesting the Bank to issue the guarantee in favour of UAL. The guarantee provided that the Bank was bound to pay UAL $500,000 "without condition or proof forthwith upon first written request" by UAL made on or before the expiry of the guarantee period on 31 March 2001. When the case came before the Court, that period had several months still to run.

The Court of Appeal cited a statement by Lord Denning MR in *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976 where he described performance guarantees of this kind as 'virtually promissory notes payable on demand'. As long as an honest demand is made, banks are bound to pay, which places performance guarantees on a similar footing to a letter of credit.

UAL accepted that it could at any time until expiry of the guarantee period make demand on the Bank for immediate payment of the $500,000 guaranteed. However, it stated that it did not want to do this. It preferred to place Covington into liquidation, saying that there could be a risk in recovering Covington's assets if liquidation was delayed.

Covington argued that, in terms of the statutory provision quoted above, the existence of the performance guarantee amounted to "payment" and that UAL must be considered reasonably satisfied to that extent.

The Court of Appeal held that the existence of the guarantee did not amount to "payment", although it was certainly a means by which payment could be immediately obtained. However, the Court held that the guarantee and the arrangements between Covington, UAL and the Bank amounted to the giving of a "charge" over Covington's property (the deposit account) to secure payment of its debt to the extent of $500,000.

UAL had effectively been given a priority over Covington's other creditors. It did not matter that the charge had been given before the making of the statutory demand, nor that it was not in favour of the creditor who had made the demand. If there had been any question of the solvency of the performance guarantor (which there was not), that would be a matter going to the "reasonable satisfaction" of the creditor making the statutory demand.

The appeal was allowed. Covington was given seven days from delivery of the judgment to meet the balance owing in excess of $500,000, namely $39,256.

Orix Australia Corporation Ltd v M Wright Hotel Refrigeration Pty Ltd

(2000) 155 FLR 267

Orix, a finance company, sued Wright Hotel Refrigeration, a company carrying on a commercial refrigeration business, for conversion of a cheque that Orix had drawn and crossed in favour of Wright. The cheque had been intended by Orix to finance the purchase by All Star Catering Equipment of a machine being offered for sale by Wright. Orix, in good faith, and All Star, fraudulently, had entered into an asset purchase agreement in relation to that machine. Unbeknown to Orix, All Star had never arranged to purchase Wright's machine. All Star had forged an invoice from Wright and presented it to Orix.

On receipt of the cheque from Orix, Wright assumed that it was intended to satisfy part of an existing debt owing to it by All Star. Wright banked the cheque. It was then advised by All Star that the money had been intended for the machine. But the machine was no longer available. Wright felt that it should return the money, so it sent its own cheque to All Star.

All Star defaulted in payments to Orix, which sought to recover the funds from Wright, arguing that no valid title in the cheque had passed to Wright and that the relevant dealings should be rescinded.

The Supreme Court of South Australia held that it was irrelevant that a payer believed that the payee's entitlement to receive the cheque was in respect of a transaction different from that claimed by the payee. Notwithstanding that the relevant intention was induced by fraud, where the payer intends another to be the payee of a cheque and the cheque is so paid, the payee obtains good but voidable title.

Rescission was not ordered, as Wright's rights would be adversely affected. The company was not a volunteer. It had given value for the cheque in the form of goods and services supplied until it was pointed out by All Star that it was not intended for that purpose. It then drew its own cheque in favour of All Star. Ordering rescission would have caused a substantial injustice to an innocent party. There had been a change in position. The circumstances had largely been created by Orix sending the cheque to Wright.

Royal Bank v W Got & Associates Electric Ltd

[1999] 3 SCR 408, [2000] 1 WWR 1

This case in the Supreme Court of Canada concerned whether a creditor should be liable for damages for filing, without reasonable notice, a misleading affidavit in a motion to procure a public receiver.

A bank granted a corporation a revolving line of credit. As security, the bank obtained a floating charge debenture payable upon demand, a general assignment of book debts and a personal guarantee from the corporation's president.

The corporation failed to meet the bank's request to reduce inventory. The bank also requested the corporation to bring the loan within margin after the operating line was exceeded by $130,000. In addition, despite a warning from the bank not to issue large cheques, the president issued cheques totalling $140,000, which were returned 'Not Sufficient Funds'.

After further negotiation, the bank agreed to provide additional funds in exchange for more security. However, when no further security payments were made, the bank returned the payroll cheques and notified creditors that payments should be made directly to the bank. It served a letter of demand on both the corporation and the corporation's solicitor. The same afternoon the bank brought an application for a receivership order. A receiver was appointed.

The bank sued for its debt. The corporation and its president counterclaimed for breach of contract and conversion based on the bank's lack of notice in calling up its loan and appointing a receiver. The trial Judge allowed both claim and counterclaim, with the Court finding the bank liable in tort for conversion and awarding compensatory damages, as well as exemplary damages in the sum of $100,000. The Court of Appeal upheld the trial judgment.

The Supreme Court also dismissed the appeal. The Court held that the bank was required to give the debtor reasonable notice of its intention to enforce the security and reasonable time to pay following this notice of intention.

It is clear that the Canadian law relating to the making of demand differs from that in Australia and New Zealand. However, what is particularly interesting about this decision is the Supreme Court's confirmation of exemplary damages being appropriate in these circumstances.

On the facts, the Court held that no good reason had been offered to explain why the bank gave so little notice. There was no indication that there was a cause for urgency or that the corporation would be absolutely unable to pay the debt.

Further, the trial Judge found that the bank mislead the Master in obtaining the receivership order by tendering a misleading affidavit. The two most serious errors in the affidavit were, first, a suggestion that the bank had reason to believe that the corporation would move the inventory out of its reach and, secondly, the failure to disclose that the bank had already secured its financial position by action taken in relation to the corporation's accounts receivable and perfecting the assignment of book debts.

The trial Judge found that the bank's officer swearing the affidavit failed to meet the duty of candour and good faith required for ex parte applications and, absent the false air of urgency, the order would never have been granted.

The Supreme Court wanted to send a clear message of impropriety of the bank's grave and irrevocable conduct and misuse of the judicial system by rushing to foreclose on the corporation and misleading the Judge in obtaining the receiver. The award of $100,000 exemplary damages was upheld.