SHORT NOTES AND COMMENTS

CHARGES OVER BANK DEPOSITS — A REAPPRAISAL OF THEIR CONCEPTUAL POSSIBILITY

I. Introduction

A company rich in cash often prefers to leave the money in a fixed deposit account and, instead, secures overdrafts as well as other commercial lines of credit in order to meet its commercial commitments.[1] From the customer's point of view, this arrangement permits an optimum utilisation of its cash resources. From the banker's point of view, "cash is the finest type of security available".[2] There are no problems of valuation, depreciation or realisation when cash is held to cover a banking facility.[3] However, the bank has to ensure that it will not be compelled to repay the money in the deposit account until its loans, overdrafts or other lines of credit have been repaid.[4] The customer would usually agree to accept such a contractual restriction, but "the question which arises is whether or not the customer's successor *(e.g. a* liquidator or trustee-in-bankruptcy, a judgment creditor who attaches the debt, or an assignee) will obtain better rights against the bank than the original customer's."[5] To guard against the risk that someone might acquire better right than itself, the bank requires a security interest that is proprietary in character. The problem for the bank in attempting to obtain a security interest of a proprietary character is that the law treats deposits or credit balances standing in favour of a customer as debts owed by the bank to the customer.[6] This legal perception led the House of Lords in 1972 to observe that it is conceptually impossible for a banker to obtain a security interest in the form of a lien over his own indebtedness.[7]

[1] There are several advantages in such an arrangement. First, the interest earned on the fixed deposits could be used to offset the interest charged on the overdraft and other commercial lines of credit. Secondly, banks may charge a lower interest rate on overdrafts secured by fixed deposits as compared with overdrafts secured by other forms of security. Thirdly, if the utilisation of the overdraft is for a smaller amount than the fixed deposit or is for a shorter period than the fixed deposit, the interest accruing on the deposits may adequately offset the interest chargeable on the use of the credit.

[2] See L.C. Mather, *Securities Acceptable To The Lending Banker* (4th ed., 1978), p. 257.

[3] *Ibid.*

[4] See F.W. Neate, "Set-Off" (1981) International Business Lawyer, 247, 248. See also Philip Wood, *Encyclopedia of Banking Law* (1985) at E. (2451).

[5] Wood, *loc. cit.*

[6] This debtor-creditor relationship between a bank and its customer was established in 1848 by the case of *Foley* v. *Hill* (1848) 2 H.L. Cas. 28.

[7] See *Halesowen Presswork & Assemblies Ltd.* v. *Westminster Bank Ltd.* [1971] 1 Q.B. 1, 46 *per* Buckley L.J. in a passage subsequently approved by Viscount Dilhorne, at p. 802, Lord Simon of Glaisdale, at p. 808, and Lord Cross of Chelsea, at p. 810 of the House of Lord ' judgment reported in [1972] A.C. 785.

Professor Goode subsequently observed that it is impossible for a banker to obtain a security interest in the form of a charge over his own indebtedness.[8] Professor Goode's opinion has attracted much criticism.[9] However, the recent *Charge Card Services* case adopted the views of Professor Goode and decided that the right to sue a debtor cannot be made available to the bank because, as the bank is itself the debtor, it cannot sue itself upon default of the chargor.[10]

In this paper, it is proposed to examine afresh the relevant legal rules and concepts affecting the issue. The conclusion is that contrary to the earlier views it is conceptually possible for a bank to obtain a security interest in its bank deposit by way of a charge.

II. Can a bank deposit be subject to a charge created in favour of the same bank?

The legal issue that arises in the banking context is whether a customer of a bank could charge his right to demand repayment of his deposit in favour of the same bank which legally speaking is itself his debtor for the amount standing to his credit in the deposit account. Could the customer agree that so long as there are outstanding debts owed by him to the bank, he would agree to suspend and encumber his right to demand repayment? Secondly, could the customer agree that upon default or insolvency the temporary suspension of his rights would become permanent and the legal title to the chose in action be made exclusively available to the bank so that it may apply the money in satisfaction of the customer's debt?

The legal concept that seems to facilitate such an arrangement is the concept of a charge. In *National Provincial and Union Bank of England* v. *Charnley,* Lord Atkin defined a charge in these terms:

> "It is not necessary to give a formal definition of a charge, but I think there can be no doubt that where in a transaction for value both parties evince an intention that property, existing or future, shall be made available as security for the payment of a debt, and that the creditor shall have a present legal right to have it made available, there is a charge, even though the present legal right which is contemplated can only be enforced at some future date, and though the creditor gets no legal right of property, either absolute or special or any legal right to possession, but only gets a right to have the security made available by an order of the court."[11]

However, the use of a charge transaction has been objected to by Professor Goode on the ground that a bank's indebtedness cannot be made subject to a lien.[12] It therefore must equally be true that a bank's own indebtedness cannot be subject to a charge or mortgage.[13] As pointed out by a writer, "the fallacy in this reasoning is that the asset

8 R.M. Goode, *Commercial Law (*1982), p. 721.

9 See for example the criticism by Mark Hapgood in his review of Professor Goode's book, *Legal Problems of Credit and Security* (1982) in May, 1983 I.F.L.Rev, 34.

10 In *Re Charge Card Services Ltd* [1986] 3 W.L.R. 697, 721.

11 [1924] 1 K.B. 431,449.

12 See R.M. Goode, *Legal Problems of Credit and Security* (1982), p. 83.

13 *Ibid.*

charged by a customer when charging a deposit is not the deposit itself, nor the bank's indebtedness to him, but his own chose in action (that is, the right to demand the return of the deposit) against the bank".[14] The writer went on to state that "it is illogical to argue that because the bank does not possess anything over which it can exercise a lien, so the customer does not own anything over which he can create a charge".[15]

It is widely perceived that an interest in a chose in action is transferable only by way of an assignment.[16] This is understandable as the procedures to effect an equitable assignment of a chose in action are designed to balance the inherent conflicting positions and rights among the assignor, assignee and the original debtor. For example, though not a strict legal requirement, it is usually advantageous for the assignor to give notice of the assignment to the original debtor.[17] Furthermore, it is required in equity that an assignee of a debt should make his assignor, the original creditor, a party in order primarily to bind him and prevent his suing at law, and also to allow him to dispute the assignment if he thinks fit.[18] The practical reasons for this joinder of parties is to ensure that all outstanding rights and liabilities between the parties can be settled by the court.[19] Given this convenient mechanism to settle disputes between the interested parties it was thought that the creation of a charge over a chose in action necessarily involved an assignment of the interest concerned.[20] As a result it is not difficult to find judges expressing the view that a charge operates by way of an equitable assignment of the proprietary interest in the property concerned.[21] As such, the imposition of a charge over a bank deposit in favour of a bank is objected to on the ground that a charge is nothing more than an immediate transfer of legal title to the chose in action. The transfer of legal title to the debt to the bank would extinguish the debt altogether.[22] Merger would occur as the right and liability over the same debt is now vested in the same entity, that is, the bank.[23] This view is erroneous because even accepting that a charge operates by way of an equitable assignment it is not an *absolute* equitable assignment where legal title to the chose is transferred to the assignee.[24] A charge transaction is generically different.

It should be borne in mind that a charge is a security transaction designed to confer a security interest not by way of a transfer of legal title to the property concerned but by leaving the title to the property

14 See Mark Hapgood's Review of Professor Goode's book, *Legal Problems of Credit and Security* (1982) in May, 1983 I.F.L.Rev, 34.

15 *Ibid.*

16 See for example the view expressed by Professor Koh that "the common law prefers to treat security over choses in action through the concept of assignment." Koh Kheng Lian, *Credit & Security in Singapore* (1973), p. 213.

17 For an account of what these advantages are see Koh, *Ibid., p.* 216.

18 *Per* Chitty L.J. in *Durham Brothers* v. *Robertson* [1898] 1 Q.B. 765, 769–770.

19 See W.J. Gough, *Company Charges* (1978), p. 51. Where the assignment of an equitable chose is absolute, the assignee can bring an action in his own name against the debtor. See Koh, *supra,* note 16, at p. 216.

20 *Per* Chitty L.J., *supra,* note 18 at p. 770.

21 See for example *Palmer* v. *Carey* [1926] A.C. 703, 706, and *Rother Iron Works Ltd v. Canterbury Precision Engineers Ltd.* [1973] 2 W.L.R. 281, 282, *per* Russell L.J.

22 *Per* Milieu J. in *Re Charge Card Services Ltd.* [1986] 3 W.L.R. 697, 720.

23 The concept of merger is explained in *Chitty on Contracts* (25th ed., 1986), p. 669.

24 *Supra,* note 18 at p. 769.

intact in the hands of the owner of the property. A charge could take effect merely by a direction that a debt owing shall be paid out of a specific fund.[25] Chitty J. in *Durham Brothers* v. *Robertson* observed that a charge should be more appropriately regarded as a *partial* equitable assignment.[26]

To further substantiate the point that, a charge is a security transaction that does not involve the absolute transfer of legal title to the property, Denman J. in *Tancred* v. *Delagoa Bay and East Africa Railway Company*[27] drew a distinction between an absolute assignment and an assignment by way of a charge only and held that "a charge is not one which absolutely transfers the property... but... only gives a right to payment out of a particular fund or particular property".[28] A writer similarly expressed the view that "the essence of the charge is that it is a mere encumbrance attaching to the property", and that "the chargee gets nothing entitling him in any sense to call his own".[29] If these views are accepted, it appears impossible to maintain that a charge would result in merger as the transaction does not transfer the legal right to demand repayment to the debtor, that is, the bank. Millett J. in the recent case of *Re Charge Card Services Ltd.* conceded that "no conveyance or assignment is involved in the creation of an equitable charge".[30] He accepted counsel's argument that "a charge unlike an [absolute] assignment or a mortgage would not result in the conditional release of a debt".[31]

However, another objection to the arrangement, similarly based on the misconception that a charge is in essence an absolute assignment of a debt, is advanced by Professor Goode.[32] He felt that "it is the essence of assignment of a debt that the assignee becomes entitled to recover the debt. But here the debtor is the bank, which cannot legally sue itself. It follows that the customer's assignment to the bank of his own right of action against the bank is a nullity, for it transfers nothing".[33] Millett J. in *Re Charge Card Services Ltd.*[34] also felt that the right to sue a debtor cannot be made available to the original debtor, just as it cannot be conveyed or assigned to him, because the result is the same — the debtor cannot sue himself upon default of the chargor.[35]

It is submitted that these arguments have completely overlooked the true nature of a charge transaction. We have already noted that a charge, unlike a mortgage, does not involve an absolute assignment where legal title to the property is transferred to the assignee. A charge is only a partial assignment as the legal title to the property or chose is

25 *Per* Chitty J. in *Durham Brothers* v. *Robertson supra,* note 18, at p. 769.
26 *Ibid.*
27 (1889)23Q.B.D. 239.
28 *Ibid.,* at p. 242.
29 See D.W. McLauchlan, "The Concept Of A Charge In The Law Of Chattel Securities" (1980) V.U.W. Law Rev. 283, 289.
30 [1986]3W.L.R. 697, p. 720.
31 *Ibid.,* at pp. 719–720.
32 See Goode, *supra,* note 12 at p. 86.
33 *Ibid.,* at p. 87.
34 *Supra,* note 10 at p. 721.
35 *Ibid.,* at p. 721.

not transferred but is merely encumbered.[36] If the legal right to sue the bank is made subject to a charge, then similarly, the legal right to sue is not transferred but is merely encumbered. This being the case, the enforcement of the charge upon default by the bank cannot be by way of exercising the right to sue. However, this does not mean that the transaction, as alleged by Professor Goode is a nullity. The transaction is still capable of conferring proprietary rights on the chargee because upon default, or upon any instance of inconsistent dealings by the chargor, equity would intervene and *new* rights would come into existence on those contingencies.[37] In *Re Charge Card Services Ltd.* Millett J. himself observed that it is "the availability of equitable remedies that has the effect of giving the chargee a proprietary interest by way of security in the property charged".[38] It is implicit in Millett J.'s statement that he acknowledged that the chargee's proprietary interest arises because of equity's intervention and not because the debt has been transferred. As a further illustration of how proprietary rights are "created" by equity and not transferred the following judicial statement in *Mathews* v. *Goodday* is most instructive:

> "[A] charge at law conferred no proprietary rights and the creditor had only a personal action in contract. Equity intervened, however, and gave the chargee a right to have the property applied to the satisfaction of the debt in preference to all subsequent claimants except, of course, the bona fide purchaser for value of the legal title without notice."[39]

In fact, even before default, the chargee could acquire some sort of proprietary interest over the charged property because of the court's willingness to restrain dealings inconsistent with the charge.[40] For example, in *Brown* v. *Bateman*[41] a contractual term which gave the owner of land power to prevent the removal of the builder's building materials from the land was held to have created an equitable charge, as a result of which the court was willing to prevent the removal of these materials by the sheriff under an execution against the builder.

Thus far, it seems clear that the proprietary right of a chargee is created in equity. Its enforcement is dependent upon the court's willingness to protect the chargee's interests against the claims of other claimants. In this scheme of things, there is no reason to suggest that equity's intervention is premised upon the ability of the chargee to sue a third party. In the opinion of a commentator, the fact that the bank cannot sue itself to recover the debt assigned to it "simply illustrates that this particular form of security is realised by the bank effecting a set-off, not by the institution of proceedings against a third party."[42]

Another serious objection to the imposition of a charge over a bank deposit rests on the premise that since the chargee is also the debtor then upon default the bank's liability under the debt is automatically discharged or reduced. In *Re Charge Card Services Ltd.,*

36 See text at notes 24 and 25.
37 See E.I. Sykes, *The Law of Securities* (4th ed., 1986), pp. 17–8.
38 *Supra,* note 10 at p. 720.
39 (1861) 31 L.J. Ch. 282. See also McLauchlan, *supra,* note 29, at p. 289.
40 See Gough, *supra* note 19, at p. 17.
41 (1867)L.R. 2C.P. 272.
42 *Supra,* note 14.

Millett J. was of the opinion that such an arrangement could not create a charge, but would only in substance give a right of set-off, which would be effective to the extent that it is consistent with and does not go beyond the statutory right of set-off provided for by the insolvency legislation.[43] It is conceded that because the chargee and the debtor were the same entity in this particular situation the realisation and application of the bank deposit for the satisfaction of debts owed to the bank was basically a set-off process where a claim and counterclaim are mutually extinguished. But to say that a charge over a bank deposit is therefore in substance a set-off is unreasonable. The effect of a charge is to make the chargee a secured creditor entitled to the property charged in preference to other unsecured creditors. A set-off, on the other hand, does not make the bank a secured creditor; it merely gives the bank a right to treat two or more accounts as one. In any event, and as discussed, the incidental result of a set-off following the enforcement of the charge over the bank deposit is not inconsistent with the legal character of a charge. The courts from an early period have permitted parties to expressly stipulate remedies in a security contract convenient to them in the event of a default.[44] For example, the most common remedies expressly provided for in this way by the parties have been the power to sell or appoint a receiver out of court.[45] The only general restriction is that equity will not permit any clog or fetter to be placed upon the equity of redemption.[46] It follows that it is open to the parties in subjecting bank deposits to a charge to stipulate the remedy of a set-off in the event of a default.

Finally, whether a particular security contract gives rise to a charge or a set-off must surely depend on the intention of the parties and the surrounding circumstances and not on the manner in which the bank deposit is applied in satisfaction of a debt. Courts have on occasions been asked to consider whether a set-off agreement created a charge over the bank deposit. In *Swiss Bank Corporation* v. *Lloyds Bank Ltd.* Buckley L.J. stated that:[47]

> "Whether a particular transaction gives rise to an equitable charge of this nature must depend on the intention of the parties ascertained from what they have done in the then existing circumstances. The intention may be expressed or it may be inferred. 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 contra indication, that the parties' intention is that the creditor should have such a proprietary interest in the segregated fund or asset."

In *British Eagle International Air Lines Ltd. v. Compagnie Nationale Air France,* Lord Cross similarly emphasized the intention of the parties as the determinant factor when he said that the "clearing house" arrangements which in essence are a set-off mechanism did not constitute a charge because that was not the intention of the parties.[48]

43 [1986] 3 W.L.R. 697,721.
44 Cough, *supra,* note 19, at p. 15.
45 *Ibid.*
46 *Ibid.,* at p. 16.
47 [1982] A.C. 584, 595.
48 [1975] 1 W.L.R. 758, 780.

Finally, if banks feel that security interests could be carved out of a customer's right to demand repayment of a deposit there is no good policy reason for the courts to defeat such an arrangement merely on technical grounds. There is much merit in the candid judgment of the Earl of Selborne, L.C. in *Ex Parte Caldicott*[49] where he approved of a charge over a bank deposit simply because it was a bona fide security given under the most natural circumstances.

III. Conclusion

It is common to hear condemnation by members of the business community that certain aspects of our business law do not reflect commercial realities. In the context of our discussion, the above complaint seems legitimate. A simple arrangement to obtain a security interest over a bank deposit by the same bank is fraught with legal uncertainties. The problem seems aggravated as there is no simple and ready solution. It ought, in fact to be noted that even if the central issue in this note is ultimately resolved, yet another, no less problematic issue remains. This centres around the question as to whether a charge over a bank deposit constitutes a registrable charge under section 131 of the Companies Act.[50]

T.C. CHOONG*

[49] (1884)25Ch. D. 716.

[50] Cap. 50, Singapore Statutes, 1985 (Rev. Ed.).

* LL.B. (Warw.), LL.M. (Br.Col.), Barrister (G.I.), Advocate & Solicitor of the Supreme Court, Lecturer, Faculty of Law, National University of Singapore.