SECURITIBANK'S COLLAPSE AND THE COMMERCIAL BILLS MARKET OF NEW ZEALAND

During his long and distinguished career as a Judge of the Singapore Supreme Court, the Honourable Mr. Justice Victor Winslow handed down numerous important decisions in the field of commercial law. One of them — *Overseas Union Bank Ltd.* v. *Chua*[1] — is a leading case on the tender of certificates of inspection under documentary credits. The learned Judge's deep interest in the subject of letters of credit and of negotiable instruments renders this article — based on a paper delivered to the Wellington District Law Society in July 1977 — a suitable contribution to a publication dedicated to him on the occasion of his retirement.

I. PRACTICE

1. *Background*

The use of bills of exchange in commercial transactions is a well established business practice. Frequently, an exporter, who dispatches goods under a contract involving their transportation to an overseas destination, draws a bill of exchange for the price on the purchaser. The exporter discounts this bill with his own bankers who present it to the purchaser for acceptance and for payment through their correspondents. The exporter's bank obtains reimbursement for the amount paid to the exporter when the bill is paid by the purchaser on maturity. The shipping documents, which are usually attached to the bill of exchange, constitute the banker's security. Bills of exchange of this type — drawn against produce or goods — are known as "trade bills" and are extremely common.[2] In New Zealand they were in use as early as the middle of the 19th century. By and large, they fall outside the scope of the topic under discussion.

A more recent development, at least in New Zealand, is the use of bills of exchange as a means of financing domestic or inland transactions. Let us assume that a manufacturer requires an advance to enable him to produce a line of kitchen utensils for which there is a ready domestic market. In some cases a bank may simply grant him a loan. But occasionally the bank may be unable to raise the required amount from its own resources. It may, nevertheless, be prepared to assist the manufacturer by "guaranteeing" a loan or an advance to be obtained by him from some other financial institution. One method of attaining this object involves the issuing of an acceptance credit, in which the bank authorises the manufacturer to draw on it bills of exchange for a specified maximum amount at a given "usance" *(i.e.* a specified method of calculating the maturity date of the bill). In this type of case the bank does not advance money to the manufacturer. Instead, it "lends him its credit". The bank's acceptance gives currency to the manufacturer's bills; it enables him to discount the bills through

1 [1964] M.L.J. 165, noted in (1964) 6 Mal. L.R. 417.

2 For a full discussion of the relevant practice see *The Bill on London* (Gillett Bros., London, 1964).

a broker or a discount house. From a practical point of view, the transaction is similar to a loan guaranteed by a bank.

Bills of this type are known as "commercial bills".[3] For the sake of clarity, a model is attached.[4] It will be noted that the manufacturer, who draws the bill, is the person who issues it. In essence, he orders the drawee — the bank — to pay the bill on maturity.[5] The bank signifies its assent to this order by "accepting" the bill of exchange.[6] The acceptor, i.e. the bank, becomes the party primarily liable to pay the bill.[7] The drawer, however, does not escape liability: he warrants that the drawee — the bank — will both accept the bill and thereafter pay it on maturity.[8] It follows that, on the face of the bill, the drawer assumes the position of a surety. His liability towards the holder, or transferee, remains in abeyance unless the bank dishonours the bill either by refusing to accept it[9] or by failing to pay it.[10] In addition to assuming this liability by drawing the bill, the manufacturer, in our illustration, will also become liable as an indorser. As the bill is payable to his own order, his indorsement is required for its transfer.[11] As indorser, he engages that the bill will be duly accepted and paid.[12] The indorser's liability towards the holder is, again, that of a surety.

The respective positions of the manufacturer as a surety and of the bank as the main debtor, incurred towards third parties on the face of the bill, are reversed in the immediate contractual relationship subsisting between themselves. As against the bank, the manufacturer is deemed to be the principal debtor of amounts obtained from third parties through the discount of bills drawn under the acceptance credit. The bank is deemed to be a guarantor or surety. It is therefore entitled to claim from the manufacturer any amounts paid by it to holders of bills of exchange drawn under the acceptance credit. Usually this right is expressly conferred in the credit, but it is also implied at law when the contract is silent.[13] Moreover, the manufacturer is under a duty to remit to the bank in advance the funds needed to meet bills of exchange at their maturity date.[14]

2. *Securitibank*

The use of bills of exchange drawn under acceptance credits is not a novelty. In the United Kingdom, this type of facility can be traced back to the second decade of the 19th century. In New Zealand, however, this type of transaction remained rare until approximately

[3] See, generally, Robertson, "Commercial Bills of Exchange used for Finance Purposes in New Zealand", 3 *Auckland L. Rev.* 1 (1976).
[4] *Post,* p. 110.
[5] Bills of Exchange Act 1908 (N.Z.), s. 3(1).
[6] B.E.A., s. 17(1).
[7] B.E.A., s. 54(1).
[8] B.E.A., s. 55(1).
[9] B.E.A., s.43(2).
[10] B.E.A., s. 47(2).
[11] B.E.A., s. 31(4).
[12] B.E.A., s. 55(2).
[13] *Re Yglesias, ex p. Gomez* (1875) L.R. 10 Ch. App. 639, 645.
[14] *Overend Gurney & Co.* v. *Oriental Financial Corporation* (1874) L.R. 7 H.L. 348.

the 1960s, the very period in which merchant bankers made their appearance on the local scene.

One of the most prominent groups which became operative in this field was Securitibank. The group comprised several companies, each of which had a separate function. Securitibank itself was the holding or parent company and also solicited deposits from the public. One of the subsidiaries was engaged in short-term money market transactions (i.e. the sale and re-purchase of marketable government stock). Another subsidiary dealt in contributory mortgages and still another — Safe Custody Nominees Ltd. — had the function of holding securities deposited with other members of the group. The two subsidiaries, which are of particular interest in respect of this discussion, are Merbank and Commercial Bills Ltd. The former was the "lending arm" of the group and the main issuer of its acceptance credits. The latter, a discounting house, negotiated bills accepted by Merbank and arranged for re-discounts.

For a number of years the entire group appeared to prosper. Attractive advertisements and interest rates enabled it to secure a substantial slice of the domestic market in commercial bills. Indeed, in 1974-75, its bills transactions amounted to $30m., which was about one fifth of the total of outstanding domestic bills. Except to those endowed with foresight, the group's credit rating was excellent. Bank references relating to it were favourable. Then, right out of the blue, its solvency and business acumen were questioned by a weekly paper. The group's spokesman refuted the allegation and the firm went so far as to sue the paper in defamation. An ensuing war of communiques spread over a few weeks. It ended with the appointment of a provisional liquidator.

It turned out that the group was unable to meet its financial obligations. The main cause for its collapse was an old and notorious one: the group had, effectively, borrowed short and lent long. By way of illustration, the group invested short term deposits in land development schemes. There was no doubt that the group had substantial assets and securities. But its liquidity was impaired beyond redemption. Moreover, the foreclosure and forced sale of commercial properties owned by the group or mortgaged to it would have led to a general depression of real estate values in New Zealand. A gradual winding-up process, stretching over a number of years, may be safely predicted.

It is important to emphasise that the cause of the group's collapse is not to be found in the mechanics, or legal devices, used for its financial transactions. Neither the use of acceptance credits nor the discounting of bills of exchange is, in itself, imprudent. The blame would appear to rest with the management, which displayed poor business judgment and pursued an unsound financial policy.

The consequences of Securitibank's collapse will of course be serious for New Zealand's business world. Many individuals and business concerns stand to lose substantial amounts of money invested with the group. Prolonged litigation for the determination of priorities is inevitable. It is not surprising that the group's collapse led to a

general outcry directed at the inadequacies in the existing law. It was widely felt that the law ought to have precluded this type of financial disaster. This general demand for reform, echoed by the news media, induced the Justice Department to appoint a Working Group, instructed to report on the existing state of the law and to make proposals for suitable amendments. This paper is based, to a certain extent, on some of the topics studied by the Working Group.[15] Naturally, certain aspects have to remain confidential. Most of the facts to be discussed are therefore based on materials which are available to the public.

3. *Securitibank's acceptance credits*

Before turning to some of the specific legal problems studied by Working Group, it will be convenient to study Securitibank's business practice relating to acceptance credits. Other business transactions of the Securitibank group need not be studied as they are irrelevant to the topic now under discussion.

Most acceptance credit operations of the Securitibank group constituted co-ordinated transactions involving a client, Merbank and Commercial Bills. It will be useful to turn back to the earlier illustration of an acceptance credit granted to a manufacturer. Usually, such a client's dealings were with Merbank, who approved the acceptance credit and obtained a suitable security, such as a chattel's mortgage over the manufacturer's equipment or stock in trade or a floating charge. The bills drawn by the manufacturer and accepted by Merbank were discounted by Commercial Bills. Both firms obtained a remuneration. Suppose the manufacturer required $150,000. The interest to be charged, say $15,000 for a period of one year, was added to the capital, so that the amount of the credit was $165,000. In addition, Merbank charged an agreed percentage as an "acceptance fee", debited to the manufacturer's account. Commercial Bills, who deducted the discount charge of $15,000 at source, paid the manufacturer the nett amount of $150,000.

In this way, Commercial Bills became the holder of a bill of exchange for $165,000. It was, as outlined above, a bill bearing the signature of Merbank as acceptor and that of the manufacturer as drawer and as first indorser. This type of bill became known as "clients' bills". Commercial Bills now had three alternatives:

1. It could retain the bill in portfolio and, in this way, reap the full profit of $15,000;
2. It could re-discount the bill. Indeed, in a number of cases clients' bills were re-discounted by individuals or by business firms, who had the required amounts for the respective period of the bill. The re-discount charge was usually lower than that of the original discount charge. If, for example, the re-discount charge was $12,000, then Commercial Bills earned the balance of $3,000.
3. In some cases it was impossible to arrange for a re-discount of the client's bill, e.g. because of the difficulty in finding a single

[15] The Working Party appointed by the Minister of Justice reported on 1 August, 1977. The writer was a member of the Party. Any errors made in this article are, however, my sole responsibility.

investor prepared to invest the full amount involved for the relevant period of time. It might, however, be possible to find a number of investors each of whom was in a position to invest a fraction of the amount. A fractional indorsement of a bill to several parties was, of course, precluded.[16] In cases of this type, Commercial Bills solved the problem by drawing its own bills on Merbank. This was done under a global acceptance credit, opened by Merbank in favour of Commercial Bills. The bills drawn under this acceptance credit had two signatures: that of Commercial Bills as drawers and that of Merbank as acceptor. Commercial Bills raised money against these bills by discounting them with investors, adding its indorsement in blank. This type of bill became known as "investors' bills". Under the terms of the global acceptance credit, Commercial Bills undertook to deposit securities, covering the amounts of the accepted bills, in favour of Merbank with Safe Deposit Nominees. Frequently, the securities, deposited in conformity with this arrangement, were the very clients' bills accepted by Merbank and discounted by Commercial Bills.

Any one of the three arrangements involved could work satisfactorily in the illustration concerning the acceptance credit opened in favour of a manufacturer. At the end of the 12 months period involved, the manufacturer would have sold his utensils and, from the proceeds, would have placed Merbank in funds to enable it to meet the bill drawn by him. A re-discounter of the manufacturer's bill, or the holders of investors' bills drawn in connexion with it, could therefore be paid. The position was, however, very different if the client was not a manufacturer, who required the amount advanced solely for the period agreed upon originally, but a land-developer, who, in reality, required finance for a considerably longer period than the 12 months agreed upon initially. When his original bill for $165,000 fell due, he was highly unlikely to be able to place Merbank in funds. Merbank's only option — apart from instituting bankruptcy or winding up proceedings — was to grant the land-developer a new acceptance credit. This time the amount of the credit would cover the original $165,000 plus the fresh interest or "discount charge" and the developer would, in addition, be charged a further acceptance fee. The new bill drawn by the land-developer under the second acceptance credit would again be discounted by Commercial Bills and the paper-proceeds be used to retire the original bill. This type of transaction is known as "rolling bills" and is not as uncommon as one would have hoped. The substantial increase in the amount of the interest charge is a consequence of the "compounding" occasioned by the procedure.

It is worthwhile adding that, in some cases, Merbank did not "roll" a bill but allowed the sum due under the original acceptance credit to stand as an overdue debt carrying interest. The object was to avoid a discharge of the original debt and its substitution by a new indebtedness, which would have ranked lower than any secured debt incurred by the client during the currency of the original acceptance credit.[17]

[16] B.E.A., s. 32(2).

[17] *Delaines* v. *Noble, Clayton's Case* (1816) 1 Mer. 572 and *Hopkinson* v. *Rolt* (1861) 9 H.L.C. 514 as explained in *West* v. *Williams* [1899] 1 Ch. 132.

This then was the acceptance credits practice of Securitibank. It is interesting to consider why this financial method was being used. After all, the very same operations could have been carried out by means of loans, granted to the client by Merbank or by Commercial Bills. To finance these operations, Securitibank could have raised money from the public on fixed deposits or by issuing debenture stock. What then were the incentives for employing the more complex system of acceptance credits, involving bills of exchange discounted within the group? It would appear that three factors enhanced the use of this practice.

First and foremost was the group's wish to avoid the application of the Moneylenders Act 1908. None of the members of the group were registered under the Act. Presumably, they were unwilling to comply with the onerous disclosure provisions laid down in section 8 of the Moneylenders Amendment Act 1933. The prohibition of compound interest, under section 9 of the same Act, was in all probability another disincentive to registration. By using a practice involving the discount of bills of exchange, the group sought to escape the application of the Act.[18]

It may be asked whether the group might not have been unnecessarily apprehensive as it was in any event unaffected by the Moneylenders Act 1908 by reason of its being a bank.[19] It is, indeed, undeniable that the group, as a whole, engaged in most types of banking business with the exception of the opening of current accounts operable by cheques and of foreign exchange transactions. Existing case law suggests that, under the circumstances, the group might have been considered to be engaged in banking business and hence to be entitled to claim that it was exempted from the application of the Act.[20] The group, however, was split into separate companies, each forming a distinct legal entity and each confining itself to only one or two specialised types of business. *United Dominions Trust* v. *Kirkwood*[21] establishes that, in view of these circumstances, none of the branches of the group constituted a bank. In point of fact, the group had good reasons to wish not to be regarded a bank. At the outset, it was not keen to fall within the stringent controls exercised over banks by the Reserve Bank. In addition, the incorporation of a bank is prohibited by section 458 of the Companies Act 1955. The courts have the power to issue an order — in lieu of a writ of *scire facias* — to de-register a company which, in contravention of this section, engages in banking business.[22] It follows that the group had good reasons for wishing not to be regarded a bank. Its safest way to avoid the application of the Moneylenders Act was, thus, to engage in

18 *Chow Yoong Hong* v. *Chung Fah Rubber Manufactory* [1962] A.C. 209, 215; see also, as regards the discount of book debts, *Olds Discount Co.* v. *John Playfair Ltd.* [1938] 3 All E.R. 275.

19 S. 2.

20 See generally *Re Shield's Estate* [1901] 1 I.R. 172, 198; *Bank of Chettinad* v. *Income Tax Commissioner of Colombo* [1948] A.C. 378 and, in particular, *Commissioners of the State Savings Bank of Victoria* v. *Permewan, Wright & Co.* (1915) 19 C.L.R. 457, 470-71; *Royal Bank of Canada* v. *I.R.C.* [1972] 1 Ch. 665.

21 [1966] 2 Q.B. 431, 476.

22 Civil Procedure Code, rule 312; and see generally *Riche* v. *Ashbury Carriage Co.* (1874) L.R. 9 Ex. 224, 263-264; *Bonanza Creek Gold Mining Co.* v. *R.* [1916] 1 A.C. 566.

transactions which did not constitute loans. The discount of bills issued under acceptance credit happened to provide a perfect solution.

The second factor that was, in all probability, an incentive for the use of acceptance credits in preference to loans was Securitibank's determination to avoid the prospectus provisions of the Companies Act 1955. Under section 48A, any invitation to the public to deposit money with, or to lend money to, a company is deemed to be an invitation to subscribe for debentures. Moreover, the advertisement itself is deemed to be a prospectus, except in so far as it discloses certain stipulated financial details and, in addition, makes it clear that any loan or deposit of money would be accepted only if tendered with an application form supplied by the company and accompanied by a full prospectus. The effect of this section is that the prospectus provisions of the Companies Act have to be complied with whenever the public is invited to invest money in the company. However, section 48A applies only to invitations to the public to lend or to deposit money. The group concluded that advertisements inviting the public to discount bills of exchange were outside the scope of section 48A. In other words, the group assumed that both clients' bills and investors' bills could be offered to the public without the need of issuing a prospectus. A literal construction of section 48A supports the group's opinion.

The third attraction of acceptance credits and of the discount of bills drawn thereunder was to be found in the circumvention of the Interest on Deposits Regulations 1972, which laid down maximum interest rates payable to the public on deposits with banks and with other financial institutions. These regulations, repealed in 1975, did not apply to discounts of bills of exchange. The object of this apparent loophole was to allow a free market in trade and in commercial bills. To avoid an abuse of the system, bill brokers, backed by the Reserve Bank, agreed not to discount bills of exchange drawn for less than $20,000. But this restriction was maintained on a voluntary basis. Securitibank was not a party to the arrangement and was therefore within its rights when it negotiated bills for considerably smaller amounts. It is worthwhile adding, that the influence of the 1972 Regulations in diverting short term money to the bills market can be demonstrated by statistics. The commercial bills market, which before the enactment of the Regulations stood at an estimated figure of $45m., grew to $78.8m. in September 1973 and to $164.5m. in September 1974.

It seems likely that the three factors, which have just been discussed, were the main incentives for the use of the acceptance credit system by Securitibank. An additional, though secondary cause, might have been the case with which this type of transaction can be employed to disguise a long term commitment as a short term transaction. The fact that the proceeds of the discount of the bill drawn under the credit are to be streamlined into a long term transaction, such as land development, is not too apparent. One can only wonder whether — in the late stages of its activities and when the writing was on the wall — Securitibank attempted to use its commercial bills business to hide its liquidity problems. It may be retorted that it is equally possible to disguise long-term as short-term loans by providing for an unrealistic date of repayment. But an investor, who is asked to

underwrite such a transaction or to discount the book debt created by it, is more likely to investigate the financial details than a discounter of a bill of exchange, which is considered to be distinct and separate from the underlying transaction.

II. CURRENT LAW AND REFORM

1. *Defining the problems*

The extent of the losses likely to result from Securitibank's collapse remains uncertain. It may be minimised by a long term liquidation process, but, of course, some creditors may themselves become insolvent if their claims remain unsatisfied for a lengthy period of time. One thing is clear: the group's collapse has led to a remarkable unease among investors and generally in business circles. The major grounds for concern may be summarised as follows:

First, there is the problem concerning the rights of bill holders. Are they entitled to claim priority over, or a special equity in, the securities deposited with Merbank by clients who were granted acceptance credits? It will be shown that the case law in point is antiquated and uncertain. A demand for a "common sense reform" to be applied retrospectively has emanated from certain quarters.

Secondly, some complaints focused on the use of the syllable "bank" in the names of Securitibank and Merbank. It has been suggested that some investors were under the impression that they were dealing with a bank and that they were, as a result, lulled into a false sense of safety.

Thirdly, concern has been expressed about the avoidance of the prospectus provisions of the Companies Act. It is widely conceded that genuine discounts of commercial bills drawn by clients on a bank or other financial institution differ from a deposit of money.[23] It has not been suggested that such genuine discount transactions be subjected to the type of disclosure required in a prospectus. It has, however, been suggested that different considerations ought to apply to "investors bills", which constitute "in house" paper. A person, who discounts such a bill, advances money to the group against its own commercial paper. It has been argued that such bills should be deemed to be debentures and, in this manner, be subjected to the prospectus provisions.

Fourthly, concern has been voiced about the effect on the rights of the holders of a failure to comply with the procedure applicable under the Bills of Exchange Act where a bill of exchange is dishonoured by non-payment. The fact is that most bills negotiated or drawn by Commercial Bills were not delivered to the investor. Instead, they were remitted, on his behalf, to Safe Custody Nominees Ltd., who were expected to present the bill to Merbank for payment. It would appear that, when the affairs of the group took an unfavourable turn, Safe Custody ceased to present the bills. As a result, the holder might have lost his right of recourse against the drawer — e.g. the manu-

[23] The distinction, presumably, is to be found in that the discounter of such a bill obtains the joint liability of separate parties.

facturer in the illustration given above — and any indorser. Moreover, the holder could equally lose his right if Safe Custody failed to give due notice of dishonour to the drawer and to Commercial Bills upon the non-payment of a bill. It has been suggested that the sections of the Bills of Exchange Act concerning presentment for payment and notice of dishonour, as well as the provision concerning the effect of non-compliance with these requisites, require reform.

Finally, it has been suggested that it is improper to leave the access to the bills market as wide open as it is at present. Proposals for the licensing of bills brokers and of discounting houses have been forthcoming. It has also been suggested that financial houses engaging in this type of activity should carry insurance cover, or a bond, similar to that required of legal practitioners or of accountants.

The remaining part of this paper will be devoted to these problems. The problems of double bankruptcies are, by far, the most interesting ones.

2. *Double bankruptcy of drawer and acceptor of bill*

It will be recollected that bills drawn under acceptance credits were signed by the client as drawer and as first indorser and by Merbank as acceptor. When Commercial Bills re-discounted the bill with an investor, it added its own indorsement to it. The bill then came into the hands of the third party — the holder — or was held on his behalf by Safe Custody. But the third party did not acquire the securities furnished by the client under the acceptance credit. These remained in the hands of Merbank.

Obviously, Merbank and Commercial Bills have to dishonour outstanding bills. The holder, therefore, has to seek recourse to the client — the drawer. In some cases the client may be in a position to pay the bill without having to rely on the proceeds of the securities furnished by him to Merbank. In other cases, he may be able to meet the bill only by realising these securities. In still other cases, the client himself is insolvent.

Where the client is able to honour the bill without having recourse to the securities furnished to Merbank, the position is usually straightforward. The client, Merbank and Commercial Bills are jointly and severally liable to the holder of the bill.[24] The client, in addition, is bound under the terms of the acceptance credit to place Merbank in funds to enable it to meet the bill. He therefore faces the danger of being required to pay twice: once to Merbank and, upon Merbank's dishonour of the bill, to the holder. Fortunately, there is a valid way of overcoming this hazard. The client's best course is to refuse to remit the amount due under the acceptance credit and to await the bill's dishonour by Merbank. Once the bill has been dishonoured, he should pay it directly to the holder.

This suggestion is based on an analysis of the transaction. In the acceptance credit Merbank promises to the client that it will accept and pay bills drawn thereunder. In other words, it undertakes to

[24] B.E.A., s.47(2).

discharge such bills. Merbank's inability to pay the bill amounts to a total failure of the consideration furnished by it. It follows that when Merbank has dishonoured the client's bill, it holds his securities without consideration and is, therefore, bound to release them. This submission is supported by *ex p. Waring* [25] — to be discussed at length subsequently — and by the earlier case of *ex p. Pease.*[26] Recent support is provided by *Sale Continuation Ltd. v. Austin Taylor & Co.*[27] Selling agents, which for all practical purposes stepped into the shoes of the importer, instructed a merchant bank to open a documentary credit in favour of the exporter. In due course, the bank accepted a bill drawn by the exporter and accompanied by the required shipping documents. The bank released these documents to the selling agents under a trust receipt, in which the agents undertook to hold the goods in trust for the bank and to remit to the bank the proceeds of their sale so as to enable the bank to pay the exporter's bill of exchange at maturity. The merchant bank failed before the bill became due. It was held that the selling agents were entitled to pay the amount of the bill, which was in effect equal to the price of the goods, directly to the exporter and, by so doing, to discharge their liability under the trust receipt. The bank could not, at one and the same time, hold the selling agents to their undertaking in the trust receipt and dishonour the exporter's bill of exchange. The bank's inability to honour the bill constituted a total failure of the consideration furnished by it to the agents. In other words, the bank could not retain the security whilst failing to perform the bargain for which it had been furnished.

The very same principle ought to apply in the type of case under consideration. When Merbank fails to pay the bills drawn under its acceptance credit, it cannot retain securities furnished thereunder. The only argument that may be raised against this submission is that, when the client pays the bill to the holder, the bill itself is not discharged and that, therefore, Merbank is not discharged from its liability on the bill. If this were so, Merbank could, indeed, purport to retain the securities furnished by the client. At first glance, section 59(2), under which a bill is not discharged when it is paid by the drawer or by an indorser, lends support to this argument. But further considerations refute it. The section provides that where a drawer pays the bill, he is entitled to enforce it against the acceptor. As the drawer — i.e. the client — becomes the person entitled to enforce the bill, he is *a fortiori* entitled to the benefit of the securities furnished to the acceptor for this purpose. Moreover, under section 59(3), "when an accommodation bill is paid ... by the party accommodated, the bill is discharged". It is arguable that the client is such an "accommodated party", because the bill drawn under the credit is accepted for his accommodation by Merbank — "the accommodation party". Under section 28(1), an "accommodation party" is a "person who has signed the bill as drawer, acceptor, or indorser, without receiving value therefore, and for the purpose of lending his name to some other person". There can be no doubt about the applicability of the latter part of this definition. By accepting the client's bills,

[25] (1815) 19 Ves Jun. 345.

[26] (1814) 19 Ves. Jun. 25; see also *Re Yglesias, ex p. Gomez* (1875) L.R. 10 Ch. App. 639.

[27] [1968] 2 Q.B. 849.

Merbank facilitated their discount and, thus, lent its credit. But as Merbank obtained an acceptance fee from the client, can it be asserted that it lent its name without obtaining value? Cases decided before the enactment of the Bills of Exchange Act, suggest that this type of fee does not preclude Merbank from being an accommodation party.[28] It is submitted that the Act has not changed the state of the law and that the clients' bills constitute accommodation bills. It follows that, under section 59(3), payment by the client discharges the bill and Merbank's liability on it.

On this basis, a client who is able to meet the bill drawn under Merbank's acceptance credit out of his own funds, is entitled to regain his securities. However, he would be well advised not to pay the bill before its dishonour by Merbank. Until such dishonour, the client cannot claim that the consideration provided by Merbank has failed in toto. After all, it is theoretically possible that the liquidator will decide to honour some bill out of the proceeds of the securities. This point is by no means academic: it was the basis of the decision in *Re Agra and Masterman's Bank, ex p. Tondeur.*[29] Once Merbank has dishonoured a bill, the client's right to regain securities is, it is submitted, unquestionable.

The client is in a less favourable position, where he can meet the bill only out of the proceeds of the securities granted to Merbank. Unless he discharges the bill, Merbank is entitled to retain the securities. It would appear that two alternative courses are open to the client. The first is to obtain bridging finance from some other source in order to enable him to pay the bill. In this way, he can regain the securities. The second is to dishonour the bill. This course is likely to lead to his bankruptcy. The situation will then be that of a double bankruptcy of the drawer (the client) and the acceptor of the bill (Merbank).

Where there is such a double bankruptcy, the holder of the bill of exchange, who has the joint obligations of the drawer and of the acceptor, is entitled to prove against both estates for the full amount of the bill.[30] Frequently, however, the dividends paid by the two estates will be insufficient to cover the full amount of the bill.[31] It is important to consider whether, as an alternative course to proving against the two estates, the holder is entitled to demand that any securities given by the drawer to the acceptor be utilised to pay the bills. In the case of Securitibank's collapse, the question, thus, is whether the securities given by the client to Merbank ought to be used to pay the full amount of bills to the holders thereof.

[28] *Re Yglesias, ex p. Gomez* (1875) L.R. 10 Ch. App. 639 *per* James L.J. at p. 643.

[29] (1867) L.R. 5 Eq. 160.

[30] *Re Comersall* (1875) 1 Ch.D. 137; *Jones* v. *Gordon* (1877) 2 App. Cas. 616; *Williams on Bankruptcy,* 18th ed., pp. 201-204.

[31] Note that the holder is not entitled to recover more than 100 cents in the dollar; note also that, under the rule against double proof, the accommodation acceptor, who is a surety, cannot prove against the drawer, the principal debtor, once the holder of the bill, who is the creditor, has lodged a proof: *Re Moss* [1905] 2 K.B. 307; cf. *Re Melton* [1918] 1 Ch. 37; *Re Fenton* [1931] 1 Ch. 85 affid. [1932] 1 Ch. 178; *The Liverpool* (No. 2) [1963] P. 64; for the basic principle see: *Re Oriental Commercial Bank, ex p. European Bank* (1871) L.R. 7 Ch. App. 99, 103; *Re Hoey* (1919) 88 L.J.K.B. 273. Similarly the surety can make no claim based on amounts due but not paid by him to the creditor: *Re Fenton, supra.* See, generally, Williams, *op.cit.,* pp. 205, 215.

The leading case in point remains the decision of Lord Eldon in *ex p. Waring.*[32] A merchant was granted a drawing facility by his bank. In this facility, which was similar to a modern acceptance credit, the bank agreed to accept bills of exchange to be drawn on it by the merchant and, as security, obtained from the merchant bills of exchange payable to himself, a mortgage over some land and a lien over the merchant's cash balance. The bank became insolvent while some of the bills drawn by the merchant remained outstanding; the value of the securities held by the bank at that time was, however, considerably higher than the amount of these bills. Shortly thereafter the merchant was also adjudicated a bankrupt. The holders of the bills accepted by the bank claimed to be entitled to have them paid in full out of the proceeds of the securities.

Lord Eldon granted the holder's petition. He emphasised that the holders had no equitable lien or other right over the securities. The bank was not the holders' trustee and did not retain the securities on their behalf. Indeed, if there had not been a double bankruptcy, the holders would have had no claim to the securities. Nevertheless, Lord Eldon concluded that the securities ought to be applied, in the first place, to satisfy the claims of the bill holders. He based this decision not on a right acquired by the holders but on the concurrent rights of the two bankrupt estates. If there had been no bankruptcy at all, the merchant would have been unable to regain the securities unless he remitted to the bank the amount due under the acceptances. He could not reclaim the securities without discharging the bank from its liability to the holders. Lord Eldon then referred to the occurrence of the bankruptcies and observed: "The bill holders must be paid, not as having a demand upon these funds in respect of the acceptances they hold; but as the estate of (the bank) must be cleared of the demand (based on) their acceptances; and the surplus, after answering that demand, must be made good to (the merchant)."

This passage, cited from the report in *Vesey Junior,* is somewhat terse, not to say obscure. After all, why should the bill holders obtain, in this manner, a priority over the general creditors of the two bankrupt estates? The report in *Rose's Bankruptcy Cases,* which tallies with the report in *Glyn & Jameson,* throws further light on Lord Eldon's reasoning. His main point, according to these reports, was that the double bankruptcy of drawer and acceptor led to a stalemate. The bank (the acceptor) could not utilise the securities obtained from the merchant (the drawer) without discharging the acceptances, for the payment of which the securities were earmarked. The merchant, in turn, could not demand the return or release of the securities without discharging the bank from its liability under the acceptances. As both parties were bankrupt, neither had the financial means to discharge his respective obligation. Lord Eldon concluded that the only solution was to break the deadlock by ordering that the securities be utilised to discharge the bank's liability under the bills. It is clear that Lord Eldon's decision was largely motivated by the fact that the value of the securities exceeded the amount due under the bills. He allowed the bill holders to reap the bonanza of obtaining first priority; but the merchant's estate obtained the benefit of acquiring the balance of the proceeds of the securities.

[32] (1815) 19 Ves. Jun. 345; 2 Rose 182; 2 Glyn & Jameson 404.

The reports in *Rose* and in *Glyn & Jameson* suggest that Lord Eldon considered the rule as confined to the specific circumstances of the case before him. Unfortunately, this did not emerge from the report in *Vesey Junior,* which was the only one consulted by the Full Court of Chancery in *Powles* v. *Hargreaves.*[33] This was another case involving a double bankruptcy of the drawer and acceptor of bills but the facts differed from those in *ex p. Waring* in that the value of the securities was less than the amount due under the bills. Lord Eldon's reasoning, as emerging from the reports in *Rose* and in *Glyn & Jameson,* would suggest that the rule in *ex p. Waring* ought to have been inapplicable. As the proceeds of the securities were insufficient to meet the bills, the payment thereof to the holders could not exonerate the acceptor from his liability under the acceptances. Moreover, the drawer's estate did not stand to derive any benefit from the application of the proceeds of the securities in partial payment of the bills: there was no surplus to be shared by the drawer's general creditors. Nevertheless both Stuart V.C., who heard the petition, and the Full Court of Chancery presided by Lord Cranworth L.C., applied the rule in *ex p. Waring.* Relying solely on the report in *Vesey Junior,* his Lordship concluded that that case had established a positive rule of law conferring on the bill holders, in the event of the bankruptcies of both the drawer and the acceptor, a right to be paid in full out of the proceeds of securities granted by the drawer to the acceptor to cover the latter's liability on the acceptances. It was, thus, decided that the proceeds of the securities were to be applied in partial satisfaction of the claims of the holders who were in addition allowed to prove against both estates for the balance.

The rule in *ex p. Waring,* as explained in *Powles* v. *Hargreaves,* has been followed in too many cases to be seriously questioned today. Admittedly, it was excluded from the bankruptcy law of Scotland in *Royal Bank of Scotland* v. *Commercial Bank of Scotland.*[34] In New Zealand, however, it was adopted in *B.N.Z.* v. Warn.[35] It may seem strange that a rule, decided one hundred and fifty years ago, has remained relevant in the present, modern, industrialised civilisation. But it has not been refuted by either authority or by textbook writers.

As the rule remains good law, it is important to consider whether or not it is applicable in the circumstances prevailing in Securitibank's collapse. The answer depends largely on some limitations imposed on the rule in *ex p. Waring* in subsequent case law. These decisions can be conveniently discussed with direct reference to the business practice of the group.

The most important distinction between the type of drawing facility used in *ex p. Waring* and in *Powles* v. *Hargreaves* and the business practice of Securitibank is to be found in the exact nature of the deals covered by the respective agreements. In the two cited cases, the transaction between the client and the acceptor encompassed a single drawing facility, allowing the client to draw bills within a given ceiling. Securitibank, on the other hand, tended to have more extensive dealings with their clients. There were cases in which

33 (1853) 17 Jur. 612 affirmed *ibid.* 1083.

34 (1882) 7 App. Cas. 366.

35 (1872) Mac. 1063.

Merbank made direct advances to clients in addition to the opening of the acceptance credit. In other cases there was an arrangement for the discounting of the client's book debts. This meant that, in many cases, the client was financed on the basis of an account current and that the securities given by him covered not only the amount drawn under the acceptance credit but also his general indebtedness to Merbank. Does the rule of *ex p. Waring* apply in cases of this type? Three decisions suggest it does not; two decide that it does.

The first of the three decisions is *Trimingham* v. *Maud.*[36] A London importer employed a factor in Barbados, who regularly indorsed bills of exchange drawn on the importer by suppliers of goods purchased through the factor. Occasionally, in order to raise money for his own requirements, the factor drew his own bills on the importer and arranged for their discount. To enable the importer to meet these bills, the factor usually sent to the importer "remittances", i.e. bills of exchange drawn by merchants in Barbados on London houses. However, the notes accompanying these remittances did not specifically earmark them for the payment of particular bills drawn by the factor on the importer. The proceeds of the remittances were therefore credited to a current account opened by the importer in favour of the factor. Both the importer and the factor became insolvent. Giffard V.C. decided that the holders of the bills drawn by the factor on the importer were not entitled to be paid in full out of the proceeds of the remittances, as these were held by the importer to cover the factor's general indebtedness (including, e.g., claims relating to goods supplied to the importer) and were not appropriated to meet the factor's bills. The two remaining cases — *Re N.Z. Banking Corporation, Levi's Case*[37] and the earlier case *ex p. Johnson*[38] — were similar.

The opposite view is supported by *City Bank* v. *Luckie.*[39] Here a merchant bank of London granted a drawing facility — described as a "cash credit" — for Stg.£75,000 to a client, obtaining as a security a mortgage over the client's estate in Guiana. Thereafter the bank regularly accepted bills drawn on it by the client, debiting the client's current account with the amounts paid. Both the bank and the client were adjudicated bankrupts. The client's account, at that time, had a credit balance of Stg.£700, which did not however take into account the amount of outstanding bills. The holders of bills drawn by the client moved that the bills be met from proceeds to be realised from the sale of the mortgaged estate. Stuart V.C. dismissed the petition. He thought that, as the mortgage over the estate was given to secure the client's general indebtedness to the bank, the bill holders were not entitled to any special right or priority. The Court of Appeal in Chancery reversed his decision. Lord Hatherley L.C. referred to the reasoning of Lord Eldon, and thought that in the case at Bar, as in *ex p. Waring,* there would be a deadlock resulting from the fact that the mortgaged property was available neither to the bank nor to the client until the discharge of the liability incurred towards the holders. He treated the amounts due on the bills as if they were advances made to the client on current account, but thought that this

[36] (1869) L.R. 7 Eq. 201.
[37] (1869) L.R. 7 Eq. 449.
[38] (1853) 3 De G., M. & G. 218 (Lord Cranworth).
[39] (1870) L.R. 5 Ch. App. 773.

did not exclude the rule. A similar view was expressed in *ex p. Ackroyd.*[40]

Initially, *City Bank* v. *Luckie* and *ex p. Ackroyd* appear to conflict with *Trimingham* v, *Maud* and the two cases supporting it. But although both groups of cases concern current account financing, there is one distinguishing factor. Whilst the transactions between drawer and acceptor, in *City Bank* v. *Luckie* and in *ex p. Ackroyd,* were maintained on the basis of an account current, the security given by the drawer was specifically earmarked for the sole purpose of meeting the bills drawn on the acceptor. The reasoning of Lord Eldon was, clearly, applicable. In *Trimingham* v. *Maud* and in the other two cases in point, there was no such appropriation. It was therefore concluded that the securities covered the drawer's total current account indebtedness to the acceptor. Consequently, Lord Eldon's reasoning could not apply. To regain the securities, or to obtain their release, the drawer's estate had to satisfy its entire indebtedness to the acceptor's estate. The securities, therefore, were realised for this purpose. Thereafter, the drawer's estate was entitled to acquire the balance.

It follows that the rule in *ex p. Waring* applies only in so far as the security furnished by the drawer is specifically appropriated for the sole purpose of facilitating payment of the bills drawn on the acceptor. This is bad news for many of the holders of "clients' bills" drawn under Merbank's acceptance credits. As pointed out above, the usual practice of Merbank was to stipulate that the client's security covered his entire indebtedness. This clause might not be fatal to the holders' claim for priority if, in point of fact, the dealings between Merbank and the client remained confined to bills drawn under one acceptance credit. Moreover, the *Waring* principle would probably apply even if the bills were rolled over and the original credit was substituted by a new one. It would, however, cease to apply if the client obtained several acceptance credits concurrently or if an additional facility or an advance was arranged for his use. One fact is clear: there is no room for a general application of the rule in *ex p Waring* to all claims made by holders of clients' bills. Each case has to depend on its own facts.

Even in cases in which the client's security has been appropriated for the sole purpose of meeting bills drawn under Merbank's acceptance credit, the bill holders may still be precluded from relying on the rule in *ex p. Waring*. An additional obstacle is placed in their way if the client's indebtedness to Merbank exceeds the value of the securities furnished by him. It will be recollected that, in *ex p. Waring,* the acceptor (i.e. the bank) was heavily indebted to the drawer. *Powles* v. *Hargreaves* may, at first glance, suggest that the rule applies even if this is not so. It is of course true that, in this case, the proceeds of the securities were applied in partial satisfaction of the bill holders, who were furthermore allowed to prove for the balance: the value of the securities was inadequate to meet all the outstanding acceptances. However, in *Powles* v. *Hargreaves* the drawer did not incur any separate debt. The drawer's entire indebtedness was related to the drawing facility and confined to bills drawn on the acceptor thereunder. This

[40] (1860) 3 De G.J. & F. 726; *cf. Re Suse, ex p. Dever* (1885) 14 Q.B.D. 611 (concerning appropriation of security to meet specific bills).

is not always the case in the double bankruptcies of Merbank and its client. Frequently, the client's indebtedness is not confined to drawings under the acceptance credit granted to him.

This type of a case is similar to *Re New Zealand Banking Corporation, Hickie & Co.'s case.*[41] The bank accepted bills drawn on it for the client's accommodation, obtaining from him as a security some share certificates exceeding the amount of the bills. However, when both parties became insolvent, the client was indebted to the bank for an amount considerably higher than the amount of the bills drawn by him. Lord Romilly M.R. held that, in these circumstances, the holders of the client's bills could not benefit from the rule in *ex p. Waring:* the bank was entitled to exercise its general lien over the securities held by it. It is believed that a similar lien accrues in favour of a merchant bank or a finance company, such as Merbank, to cover the client's entire current account indebtedness. Indeed, its existence is expressly supported by the phraseology of the standard agreements for the opening of acceptance credits used by Merbank.[42]

The cases discussed in the foregoing paragraphs constitute the main limitations on the rule in *ex p. Waring*. It may be further asked whether the rule is confined in its application to the first discounters of the bills or extends to protect re-discounters. This question will be of paramount importance as regards the rights of holders of clients' bills accepted by Merbank, as these were invariably discounted, in the first place, by Commercial Bills and re-discounted, subsequently, by an investor. The only authority in point — *Re Barned's Banking Corporation, ex p. Joint Stock Discount Co.*[43] — held that the rule in *ex p. Waring* applied to remote holders, such as re-discounter, just as it applied to the first discounter.

The above analysis demonstrates that the rights of discounters of clients' bills drawn on Merbank are far from certain. A great deal will depend on the specific facts of individual cases.

It remains to consider the rights of holders of "in house" or "investors' bills", drawn by Commercial Bills on Merbank under the global acceptance credit. It will be recalled that, unlike the clients' bills which were negotiated to investors without any reference to the securities furnished by the client to Merbank, the investors' bills were described as being covered by securities deposited by Commercial Bills. Can the holders of these "in house" bills claim any specific right over the clients' bills deposited as security with Safe Custody Nominees and, in particular, over the securities furnished to Merbank in respect of these clients' bills? Admittedly, Commercial Bills itself could, in the very least, raise a claim in respect of the clients' bills indorsed to it. The firm could, for example, demand that the client pay the bill to themselves. The discounters of the "in house" bills are, however, one step further removed and are not holders of the clients' bills. Can they, nevertheless, claim to have some right in the clients' bills and in the securities given in respect of them to Merbank? After all,

41 (1867) L.R. 4 Eq. 226.

42 Further support for this conclusion is derived from *Royal Bank of Scotland* v. *Commercial Bank of Scotland, supra,* p. 386; *ex p. Perfect* (1830) Mont. 25.

43 (1874) L.R. 19 Eq. 1; aff'd (1875) L.R. 10 Ch. App. 198.

"in house" bills held by the investors are signed by Commercial Bills as drawers and by Merbank as acceptor. Can it therefore be argued that *ex p. Waring* confers on these bill holders the right to be paid out of securities given by Commercial Bills to Merbank?

The answer, of course, depends largely on the words of the global acceptance credit granted by Merbank to Commercial Bills. It would appear that under it each security given by Commercial Bills to Merbank covered the latter's total indebtedness, accrued from time to time, to the former. They were not appropriated in specie to meet any specific "in house" bill and indeed, the "in house" bills as a group. *Trimingham* v. *Maud,* discussed earlier on, demonstrates the type of problem that arises in this type of case. Moreover, an extension of the rule in *ex p. Waring,* so as to give the holders of "in house" bills a direct right to share in the proceeds of securities given by the drawers of clients' bills to Merbank is precluded by the rule in *Vaughan* v. *Halliday.*[44] It was there held that the rule applied only where the holders of the bills were entitled to prove in the estates of both the bankrupt drawer and the acceptor of the bill. Whilst the right to prove need not be based on the bill itself,[45] it is clear that the holders of "in house" bills have no right to prove in the bankruptcy of a client of Merbank who has drawn what is here called a "client's bill". Between such a drawer and the holder of an "in house" bill there is no privity of contract or, indeed, any other direct legal relationship.

Under the circumstances, the holders of "in house" bills are unlikely to have a direct right to be paid out of the securities acquired by Merbank under its acceptance credits. It may be premature to rule out their being able to exercise some right based on tracing or on subrogation, but these possibilities appear somewhat remote.

It will now be convenient to consider the question of reform. Should the rule in *ex p. Waring* be extended to all holders of bills, regardless of the concurrent claims of the two insolvent estates and regardless of whether the holders have discounted the original bills or have acquired "in house" bills drawn against these and by Commercial Bills? Alternatively, should the rule be abolished altogether, so that bill holders would be treated as unsecured creditors, except where a valid security was specifically granted to them? Fundamentally, the question is whether or not the discounter of a bill of exchange ought to be in a more advantageous position than a general creditor.

Three arguments have been voiced in support of the retention and the possible extension of the rule. First, the rule is convenient. It facilitates the liquidation of the two bankrupt estates and puts forward a simple method for the utilisation of the securities and their proceeds. Indeed, Scot law as explained by Lord Selborne in *Royal Bank of Scotland* v. *Commercial Bank of Scotland*[46] is of a complex nature. Secondly, it has been argued that investors are entitled to be protected by the law. Some sources have gone so far as to suggest that investors, being predominantly retired persons, widows and orphans, should be given a priority over tradesmen and other general creditors.

[44] (1874) L.R. 9 Ch. App. 561.
[45] *Re Richardson, ex p. Smart* (1872) L.R. 8 Ch. App. 220.
[46] (1882) 7 App. Cas. 366, discussed above.

Thirdly, it has been contended that, at the very least, any holder who is told that his bills are secured ought to be treated as a secured creditor, i.e. as if the security be validly executed.

Several points can be raised to refute these arguments and to support the abolition of the rule in *ex p. Waring*. As against the first argument supporting the rule, it may be contended that convenience is not a sufficient ground for maintaining a rule which has an unjust result. The rule in *ex p. Waring* has such an effect. It gives all bill holders, regardless of whether they have or have not been informed about the security, a right to be paid in full out of the proceeds of securities given by the drawer to the acceptor. Why should they be granted such a right? Quite apart from the rule, they are in a position superior to that of other general creditors by being able to prove in both bankruptcies. To this right they are entitled as the drawer and acceptor are jointly liable on the bill. To give them additional rights means that they make an improper profit at the expense of the general creditors.

The second argument, supporting the holders' rights by pleading their case as investors, is without merit. On that basis, all investors, regardless of whether they have invested in bills or in unsecured deposits, should be given a priority over other general creditors. It is, however, difficult to conceive why an investor should be in a better position than some other type of creditor, such as a tradesman. It is submitted that investors have a much better opportunity to investigate the solvency of houses in which they invest than a tradesman who is asked to supply goods or to perform a service. In the prevailing, highly competitive, market, a tradesman cannot possibly be expected to pick and choose his clients or, indeed, to investigate their financial position before he accepts an order. An investor, on the other hand, has ample opportunity to study the financial market. Prospectuses are obtainable and there is no shortage of skilled advice. It may, with respect, be added that the "widows and orphans" branch of the argument is unrealistic. Persons who invest their money at high interest yields are speculators and, regardless of whether they are widows, orphans or rich financial institutions, ought to bear their risk.

This leaves the third argument, based on that some discounters of investors' bills expected to obtain a security. Admittedly, where the bill holder has acquired such a valid security, his right to enforce it cannot be doubted. But why should this principle apply where the creditor, be he a bill holder or some other type of investor, failed to ensure that his security was executed? It is easy to allege that persons do not always perform all that may be expected of them. Undoubtedly, this is so. But is it not equally true that a person's mistakes should be borne by himself rather than by others?

It is submitted that, from a purely social point of view, Securitibank's investors do not deserve sympathy. They were, predominantly, motivated by a desire to acquire a high rate of interest on their money. This applied to bill holders as much as to those who invested in other types of business transacted by the group. In a period of high inflation, this motivation is not blameworthy. But those who succumb to it must be aware of the risk.

3. *The use of the syllable "bank"*

It will be recalled that the syllable "bank" appeared in the names of both Securitibank and Merbank. Indeed, some merchant banks, which had no connexion whatsoever with the group, made a similar use of "bank".[47] It is now being claimed by some investors, that their trust in Securitibank's or Merbank's solvency and business acumen was largely based on the belief that these institutions were banks. They argue that the group should not have been allowed to register under such names.

The law in point is reasonably clear. Section 458(2) of the Companies Act 1955 prohibits the incorporation of companies which have the object of carrying on the business of banking. However, it has already been pointed out that neither Securitibank itself nor any of its subsidiaries engaged in banking business. The only other relevant provision is section 31(2)(c) of the Act, under which no company can include the word "bank" in its name without obtaining the consent of the Governor-General. Neither Merbank nor Securitibank obtained such approval. However, the section refers to the *word* "bank". It says nothing about the *syllable* "bank". Presumably, the Registrar of Companies concluded that, whilst a name such as "Mer-Bank" or "Security Bank" was prohibited, "Merbank and Securitibank" were not encompassed by section 31.

An analysis of section 31 throws doubts on the Registrar's construction. Sub-section 2(c) reads:

> "Except with the consent of the Governor-General... no company shall be registered by a name which — (c) contains the word "Bank", "Bankers", "Banking"..."

This section, thus, prohibits any name which *contains* the prohibited word. Can it seriously be contended that a name does not contain the prohibited word where it is disguised as a syllable of a longer word? Can it be alleged that "Securitibank" does not contain the word "bank" because the name comprises two words compressed into one? Similarly, can it be denied that "Merbank" includes the word "bank" preceded by the meaningless syllable "Mer"?

It is, with respect, submitted that the Registrar's interpretation defeats the object of section 31(2) (c). The purpose of the Legislature was to preclude the registration of companies which either engaged in banking business or which gave the impression that they were carrying it on. Section 458(2) served the former purpose; section 31(2)(c) served the latter. The registration of companies by a name which contained "bank", "bankers" or "banking", either as a separate word or as part of a combined word, defeated the object of these two sections.

If this construction of section 31 were correct, the Registrar had a suitable remedy to rectify the position. Under section 31 of the Act, if "through inadvertance or otherwise" a company is registered by a name which contraveness section 31, the Registrar is entitled to require it to change its name within thirty days or such longer period as is specified by him. Naturally, it is too late to use this remedy in order

[47] Note, *e.g.* Broadbank.

to force Securitibank and Merbank to change their names. Any damage resulting from the misleading effect of their names has already been done.

It would appear that the construction of section 31(2)(c) proposed in this paper has been recently adopted by the Registrar of Companies. It is understood that following Securitibank's collapse, some other merchant banks, with similar types of names, have been asked to drop the offending syllable or to change their name in some other manner. Obviously, it is advisable to amend section 31(2)(c) so as to remove any doubt.

It may, however, be questioned whether a provision of this type is desirable and whether the use of "bank" in a company's name is genuinely capable of creating a misleading impression. Are investors really likely to confuse a merchant bank with a trading bank? Would the average man in the street not be aware of the fact that institutions such as Securitibank and Merbank differed substantially from trading banks, such as the Bank of New Zealand or the National Bank, and from the regional trustee savings banks? Any person, who invested money with any merchant bank, must have noticed that no current accounts and cheque facilities were made available by it. He would be equally aware of the fact that these institutions did not provide him with occasional overdraft facilities and would not collect cheques payable to him. This must have indicated to him that, although the firm used a name including the syllable "bank", it did not perform the services rendered by trading and by savings banks.

The force of these arguments ought not to be underestimated. Their attraction lies in the support which they give to the freedom of trade. In a sense, it is oppressive to prevent a merchant bank from adopting a name which indicates the type of business in which it is engaged. The confusion that may arise from names such as Securitibank is a result of the ambiguity of the term "bank", which encompasses such different institutions as trading banks, private and trustee savings banks and merchant banks.

Nevertheless, it is suggested that, on balance, section 31 ought to be both retained and amended in the sense discussed above. It is true that there is nothing fraudulent in the use of "bank" in the name of a merchant banker. It is equally true that the word "bank" has a wide ranging meaning. In modern times, however, the word "bank" has become identified with the institutions that carry on the ordinary types of banking business. When the average man in the street speaks about a bank, he means either a trading bank or a savings bank. He thinks about an institution with which he maintains a current account or a savings account, into which his employer pays his salary and which he can use for the collection of cheques and the payment of his bills.

It follows that the use of the syllable "bank" in the name of a merchant banker can convey a wrong impression to members of the public. Whilst it may not mislead a sophisticated investor, who is familiar with the financial scene, it may confuse the uninitiated citizen, who consults newspaper advertisements in order to discover a safe investment. It is, with respect, submitted that the danger of mis-

leading the public outweighs the hardship incurred by merchant banks as a result of the prohibition enacted by section 31.

4. *Problems related to prospectuses*

As pointed out earlier on, section 48A of the Companies Act 1955 applies the prospectus provision to operations in which a company solicits funds from the public. Securitibank used *lacunae* to avoid the spirit of the section. The business practice in point disclosed a great deal of ingenuity.

It appears that prospectuses were never issued by the group. To avoid section 48A, its advertisements in the news media refrained from inviting the public to invest in the company. They simply drew the public's attention to the fact that employees of the group — wearing a distinctive badge — would be pleased to advise anyone who cared to approach them about investments. Such badge-wearing oracles could, for example, be met on airflights and, if asked for advice, would direct the inquirer to the group's offices. Another practice of the group was to solicit funds through the intermediary of accountants and of solicitors.

The use of bills of exchange was, in all probability, an extra safeguard for ensuring that section 48A did not apply. One of the group's methods of raising funds was to prepare a bill of exchange corresponding with the investor's requirements. Thus, if the investor wished to invest an amount of $10,000 for three months, Commercial Bills drew such a bill on Merbank. Naturally, if a suitable client's bill was available, the investor would be invited to re-discount it. However, the increasing amount of the bills retained by the group[48] suggests that many of their bills were not the type of paper that would invoke the trust of even indifferently informed investors.

Whilst it is possible that the advertisement of "badges" involved a contravention of section 48A, it is certain that the trade in dove-tailed bills was a successful evasion technique. The distinction between "lending" and the discount of bills of exchange is particularly well established.[49] Indeed, there exists a genuine market of commercial and trade bills, which serves an important mercantile function by providing an outlet for short term investments. It would be unrealistic to amend section 48A, so as to apply the prospectus provisions of the Companies Act to transactions on this market. The trade in bills requires prompt action and any application of prospectus requirements would be counter-productive. Moreover, the issuing of a prospectus in relation to a genuine operation in bills would be meaningless. Most commercial and trade bills are negotiated through bill brokers, who are not parties to the bill. How, then, would a prospectus issued by the bill broker be of any use to the discounter? To suggest, alternatively, that any bill proferred for discount ought to be accompanied by a prospectus of the acceptor and of the drawer, is equally unacceptable. In the first place, this type of transaction is, in the vast majority of cases, transacted by experienced businessmen, who have a good knowledge of the market. Members of the public are not encouraged or induced to participate. Secondly, not all drawers and acceptors of bills are incorporated.

48 Totalling $6m. in 1976.
49 *Ante,* p. 89.

The pertinent consideration for reform is, in effect, confined to "in house" bills. Should the discount of such bills be deemed to be an extension of a loan by the discounter to the group which issues and negotiates the bill? In addition, should an advertisement inviting the public to invest in "in house" bills be brought within the ambit of section 48A?

The argument for such a reform is self-evident. The trade in "in house" bills furnishes a loophole in the armour of section 48A, which can easily be utilised by a group like Securitibank. Also, like all loopholes, it is one that involves the use of a technicality in order to defeat the spirit of the law. It is clear that, from a commercial point of view, the negotiation of an "in house" bill is identical with the borrowing of money. Thus, the investor's chances of re-discounting an "in house" bill are unlikely to be substantially better than his chances of discounting a deposit receipt issued by the group. Moreover, the bill confers on him the right to obtain payment from two arms of the same creature. It is hard to discover an economic distinction between this right and the right to be repaid an amount lent.

There are, however, strong arguments against the suggested reform. First, any amendment will have to include a carefully drafted definition of the word "group". It would be essential to forestall the creation of a loophole, that might enable operators like Securitibank to defeat the spirit of a new Act. It is, with respect, to be doubted whether an air-tight definition is attainable. Experience shows that in most cases a sharp operator is able to find means of arranging his business in a manner that escapes a conceptual definition of this type. More often than not, this type of reform provides a stumbling block for the innocent rather than an effective means for combating the imaginative evasion schemes dreamed up by sharp businessmen and by their legal advisers. Secondly, there is a repugnant element in amending an entire branch of the law in the wake of the activities of a single operator. There is no suggestion that the regular market of bills of exchange is being conducted in an unsavoury or a disreputable manner. There is no suggestion that the amount of approximately $200m., invested in it, is in jeopardy. It is noteworthy that those who had invested in Securitibank's bills could have put their money into perfectly sound bills by conducting their business on the official bills market, albeit against a return lower than the rate paid by Securitibank. It is with respect submitted that investors motivated by greed are invariably the prey of fringe operators. One may amend the law umpteen times without protecting them from the results of their own gullibility.

It will be appreciated that the foregoing paragraphs are confined to the aspect of the reform of the prospectus provisions, which is directly relevant to the trade in bills of exchange. Other aspects will, undoubtedly, be the subject of consideration. To start with, the type of "badges" advertisement of the group gives rise to thoughts. The contents of a prospectus is another. To the uninitiated, the last accounts of Securitibank would have given no warning whatsoever. The fact that liability on bills was treated as a specific item, without regard to the nature of the underlying transactions, was capable of creating a misleading picture of the group's liquidity. One could have easily assumed that all liabilities on bills were genuinely short term.

These problems, however, are of a general nature and outside the scope of this paper.[50]

5. Procedural duties of holder and excuses for non-compliance

A particular problem which has been plaguing the provisional liquidator of Securitibank is the need to comply with the procedure which a holder of a bill has to observe in order to retain his right of recourse against the drawer and the indorser. Usually the steps to be taken by the holder are the due presentment of the bill for payment[51] and the dispatch of notice of dishonour when the bill is not paid by the drawee.[52] It will be recalled that most bills of Securitibank were deposited, on behalf of their holders or of the group, with Safe Custody Nominees. To safeguard the holders' rights, the provisional liquidator has arranged for the presentation of these bills at the bank at which they are made payable and has sanctioned the dispatch of notice of dishonour to the drawer and the indorsers, one of whom is quite frequently Commercial Bills.

As it is common knowledge that the bills in question cannot be met by Merbank, the futility of this cumbersome procedure is paramount. The liquidator's course of action, however, has been dictated by the existing provisions, under which presentment and notice of dishonour are dispensed with in very few instances. It will be useful to analyse those dispensations which may be of any possible relevance in Securitibank's collapse.

Two dispensations may be relevant as regards presentment for payment. Under section 46(2)(c) of the Bills of Exchange Act 1908, presentment is dispensed with as regards the drawer, where the drawee or acceptor is not bound as between himself and the drawer to pay the bill and the drawer has no reason to believe that it would be paid if presented.[53] Under section 46(2)(d), presentment is dispensed with as against an indorser, where the bill is accepted or made for his accommodation and he has no reason to expect that the bill would be paid if presented. The two relevant dispensations of the dispatch of notice of dishonour are set out in section 50(2). As against the drawer, notice is dispensed with where the drawee is as between himself and the drawer under no obligation to pay the bill. As against the indorser, notice is dispensed with where the bill was accepted or made for his accommodation.

Only the last mentioned dispensation appears to apply fairly and squarely to the bills drawn on Merbank. As the client is the first indorser of bills drawn under an acceptance credit and as these bills are accepted for his accommodation, he is not entitled, *qua* indorser, to notice of dishonour. As his liability as indorser is identical with his liability as drawer, it may be argued that notice need not be served

[50] These problems are within the scope of the consideration of a general reform of the requirements of publicity pertaining to invitations to invest directed to the public.

[51] B.E.A., s.45(1).

[52] B.E.A., s. 48.

[53] Primarily, this case is relevant where a person draws a cheque without having funds with the bank: *Wirth* v. *Austin* (1875) L.R. 10 C.P. 689; *Re Bethell* (1887) 34 Ch.D. 561.

on him. However, it must be remembered that, in the absence of a clear definition in the Act, it is not altogether certain that the client is an "accommodated party".[54] It follows that even this dispensation may be inapplicable. The pertinence of the remaining dispensation of notice, affecting a drawer towards whom the acceptor is not bound to pay the bill, is even less certain. On the one hand, it may be contended that if the client, the drawer, does not remit to Merbank the required funds, that firm is not bound as against him to meet the bill. Notice should therefore be dispensed with as against him. On the other hand, it must be conceded that Merbank's acceptance credits do not render the client's duty to remit the required funds a condition precedent to Merbank's promise to pay the bill. It is therefore extremely dubious whether or not this specific dispensation would apply.

The very same arguments apply in respect of the first mentioned dispensation of presentment for payment, which applies where the drawee is not bound, as between himself and the drawer, to pay the bill and the drawer has no reason to believe it would be paid if presented. As regards the first element of this dispensation, it is questionable whether the client's failure to remit the funds to Merbank discharges the latter's undertaking given in the acceptance credit. Moreover, the second leg of this dispensation — i.e. that the drawer has no reason to believe the bill would be paid if presented — is in itself no excuse for failure to present, It is provided that "the fact that the holder has reason to believe that the bill will, on presentment, be dishonoured does not dispense with the necessity of presentment."[55] The very same proviso may also pose an obstacle to an attempt to invoke the second dispensation of presentment for payment, concerning an indorser who is an accommodated party and who has no reason to expect that the bill would be paid if presented. The proviso suggests that a "mere belief" does not substantiate a dispensation; the text of the acceptance credit indicates that the indorser has no definite reason "to expect" that the bills are going to be dishonoured. There is, in the very least, a theoretical possibility that the liquidator may resolve to meet the bills. Moreover, once again it is not altogether certain that the client, the first indorser, is an accommodated party.[56] Thus, it is questionable whether or not this dispensation applies.

It would appear that the law in question is unsatisfactory. Whilst there is a theoretical possibility that a liquidator or a trustee in bankruptcy will resolve to pay a bill accepted by the insolvent drawee, the chances of such a stand being taken are remote. It is noteworthy that the futility of presenting a bill to an insolvent drawee is recognised by the Act in respect of presentment for acceptance. Under section 41 (2) (a), presentment for acceptance is excused and the bill may be treated as dishonoured where, *inter alia* the drawee has been adjudicated a bankrupt. It would be realistic to apply a similar principle in respect of presentment for payment. Indeed, such a reform has been introduced in the United States under section 3-511(3) of the Uniform Commercial Code. It may be asked whether the same reform ought to be applied in respect of the duty to dispatch notice of dishonour. On the one hand, the acceptor's insolvency is deemed to be common

54 *Ante,* pp. 93-94.
55 B.E.A., s. 46(2) (a),
56 *Ante,* pp. 93-94.

knowledge for certain purposes. It may therefore be futile to demand that notice of the dishonour of a bill accepted by the bankrupt be given to the drawer and indorsers. On the other hand, the drawer and indorsers may not be aware of the holder's identity and, as a result, may be unable to pay the bill. Moreover, unless they receive notice, they may assume, rightly or wrongly, that the bill has been paid. A drawer or indorser may, as a result, fail to exercise a right of set-off which he has against the bankrupt. It is submitted that section 3-115 of the Uniform Commercial Code, which is inapplicable to a failure of giving notice of dishonour, presents a sound approach.

Another shortcoming of the existing provisions of the Act is that they fail to take a sound approach as regards the liability of an accommodated party, who has not been given notice of dishonour or whose bill has not been presented for payment. On the one hand, neither notice of dishonour nor presentment for payment is dispensed with as regards a drawer for whose accommodation the bill has been accepted. In other words, the holder's failure to comply with the technicalities discharges an accommodated party who is a drawer. On the other hand, notice is dispensed with as against an indorser who is an accommodated party. Presentment for payment is excused as against such an indorser provided he has reasons to believe that the bill would not be paid if presented. It is, with respect, difficult to discern the logic behind these provisions. They cannot possibly be regarded as blessed with consistency. It is submitted that any party for whose accommodation the bill is made or accepted should be in the same position as the acceptor. The reason for this proposal is clear: as against the accommodation party, the person accommodated is the principal debtor. The bill is either made or accepted for his benefit. It is therefore realistic to treat him as a principal debtor regardless of the role in which he signs the bill.

It is further worthwhile examining the soundness of the entire approach of the Act to the discharge of the drawer and of the indorsers where the holder has failed to present the bill for payment or has not dispatched a notice of dishonour. Currently, the Act exonerates the drawer and indorsers from liability on the bill regardless of whether or not they have incurred any loss as a result of the holder's failure to comply with one of the prescribed steps. Noticeably, the Act itself takes a different stand where the dishonoured instrument is a cheque. Under section 74(1), where the holder fails to present a cheque for payment within a reasonable time, the drawer is discharged to the extent of the loss which he suffers from such delay. In other words, if the drawee bank becomes insolvent during the period of the delay, the drawer is discharged to the extent of the loss sustained in respect of funds maintained in his current account for the purpose of meeting the cheque. Thus, if the bank pays a dividend of 50 cents in the dollar to its depositors, the drawer is discharged to the extent of half the amount of the cheque.

It is submitted that a similar principle should be applied right across the board. An indorser and a drawer should be discharged from liability on the bill only to the extent of the loss suffered as a result of the holder's failure to present the bill for payment or to send notice of dishonour. It is further suggested that the same

principle be applied to the consequences of the failure to present a bill for acceptance.

Obviously, under the proposed provision, any discharge of the drawer or of an indorser would automatically enure for the benefit of all subsequent parties: the earlier party's discharge would necessarily affect rights of recourse of subsequent parties. The end result would, thus, be that any loss resulting from the holder's failure to comply with a prescribed procedure would be borne by himself. Such an outcome is both sound and just. Contradistinctively, the automatic discharge of the drawer and of the indorsers by reason of the holder's failure to comply with the prescribed procedures contains a Draconian element. This principle may have been justified in earlier ages, in which compliance with procedure was accorded much greater weight than in the 20th century. It may further be that some argument supporting the current provisions of the Act could, at one time, have been based on the difficulties in and on the slow speed of communications. But at the present period of time there is no good reason for retaining these antiquated sections.

It is noteworthy that the proposed reform has been adopted, in part, in the United States. Section 3-502 of the Uniform Commercial Code applies a principle similar to that of section 74 of the Bills of Exchange Act to the discharge of the drawer of any bill of exchange; the indorser's position remains, however, the same as under the English and New Zealand Acts.

E. P. ELLINGER*

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MODEL COMMERCIAL BILL

Face of Bill

MERCHANT BANK ACCEPTANCE LTD.

B.B. Street,
Wellington.

On 23rd December 1976

Pay to the order of A. Manufacturing Ltd.

the sum of $20,000 and 00 cents For value received $20,000.00 (say twenty thousand dollars)

Payable at the A.B. Bank Ltd.
62, Brandon Street,
Wellington 1

ACCEPTED 24/8/1976	DRAWN BY: P.P.
P.P. Merchant Bank Acceptance Ltd.	A. Manufacturing Ltd.
(—) Manager	(—) Manager
(—) Director	(—) Director

Back of Bill

Pay to the order of
Bills Discounts Ltd.

P.P. A. Manufacturing Ltd.
(—) Manager
(—) Director

P.P. Bills Discounters Ltd.
(—) Director
(—) Secretary