Update on the Law Relating to Set-Off

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When considering the obligations within the banker/client relationship, the rules relating to set-off are more extensive that is generally understood. They derive from various sources, the least transparent of which is the Common law. The author tried to distinguish Irish jurisprudence where it deviates from pre-State case-law.

A Banker and his client are related by contract not through any fiduciary tie. A Banker's fundamental obligation is to repay the money standing to the credit of the customer and to obey the client's instructions. The situation may arise where there is no express or written contractual term authorising a bank to exercise a right of set-off. In such circumstances, any entitlement to exercise set-off will be found at common law. There is a long line of authority dating back to the 19th Century in relation to the nature and extent of this right, as well as the limitations placed upon it. The following can be said with confidence in relation to the operation of a credit institution's right of set-off in this jurisdiction under common law:

Generally

Under Irish Law a credit institution has the right to set-off a credit balance on one current account against a debit balance on another current account.[1] Commenting on the case advanced by Counsel for the bank, Fitzgibbon J. made the following statement in *Bank of Ireland v Martin*[2]:

> "... he has boldly asserted that a banker who has monies of a customer in his hands may lawfully apply those monies in discharge of any liability of that customer to him on an account whatever. He has, I need hardly say failed to refer us to any decision, dictum or even opinion of a text-writer in support of his assertions. Of course there is authority for the proposition that where a customer has two or more current accounts, even in different branches of the same bank, the banker in the absence of any special contract, may apply a credit balance on one account to feed the debit balance upon another and that *if one account be overdrawn the banker is not bound to honour cheques drawn upon a second account which happens to be in credit, if that credit balance is less than the deficit upon the first.* But this decision, if it be of sound law, applies only to current accounts and even as regards them is subject to any arrangement to the contrary with the customer, and we have not been referred to any case in which it has been decided or even suggested that a banker may of his own motion transfer a customer's money, lodged on a deposit account, to that customer's current account in order to discharge an overdraft thereon."[3] (emphasis added)

In doing so Fitzgibbon J. tentatively approved the comments of Swift J. in *Greenhalagh and Sons v Bank of Manchester*[4] wherein the Court of Appeal determined that a bank could merge accounts of the same customer of the same type only, i.e. all the customer's deposit accounts. Distinct accounts carry with them the contractual expectation that, having been set up separately, they will remain separate.

Many commentators describe a bank's right of set-off as "the right of combination". This is because fundamental to an understanding of the right is the concept that each bank account is not a distinct debt. Rather, it is only by aggregating all the credit and debit balances that one can ascertain the true position as between a bank and its customer.[5]

An Automatic Right

It seems clear that the right of set-off arises automatically from the Banker-client relationship. Therefore, the exercise of that right does not require any prior legal proceedings. This distinguishes a bank's right of set-off from other more general

[1] See *Bank of Ireland v Martin* [1937] IR 189 and also *Flanagan v National Bank Limited* [1939] IR 352.
[2] [1937] IR 189.
[3] *ibid* at 202-203.
[4] [1924] 2 KB 153.
[5] See Breslin, *Banking Law in the Republic of Ireland*, 1st Ed. (Gill & MacMillan, 1998) ("Breslin") and also Donnelly, *The Law of Banks and Credit Institutions*, 1st Ed. (Round Hall Sweet and Maxwell, 2000) ("Donnelly"). See also the useful book by Johnson, *Set-Off Law and Practice; International Handbook,* 1st Ed. (Oxford University Press, 2006) and; Johnson and Derham (eds), *The Law of Set-Off* 3rd Ed. (Oxford University Press 2003).

forms of set-off, e.g. "legal", "equitable", "insolvency", "statutory" and "contractual" set-off. Legal and equitable set-off require a pre-existing legal action before becoming operational. Set-off within insolvency requires a debtor to become insolvent before coming into force. The contractual form of set-off requires a prior contractual agreement.

How the Right Operates in Practice

In practical terms the common law permits a bank to combine the debit and credit balances of a single customer's current accounts. As shown in the decision in *Bank of Ireland v Martin*, this entitlement applies even if, for example, the two current accounts in question were held at different branches of the same bank.[6] *Martin* is also cited by Donnelly[7] as authority for the proposition that once the right to combine balances arises, there is no obligation on a bank to obtain the customer's express consent. There is not, generally speaking, any obligation on a bank to give notice to the customer of that bank's intention to exercise the right of set-off by combining the balances on current accounts. This is unless the bank has entered into a specific agreement with its customer to the effect that it will do so, i.e. that it will provide such notice.

Limitations on the Right

A number of limitations apply to the exercise of the right. Importantly, the automatic right of set-off is limited to current accounts. Under the Common Law, there is no automatic right to combine balances between loan accounts and current accounts or between deposit accounts and current accounts. The rationale for the foregoing is that if the proceeds of a customer's current account could be set-off, at a bank's discretion, against a loan, no customer could feel any security when drawing a cheque on his current account.

Because the right of set-off does not apply when one of the accounts is a loan account or a deposit account, as opposed to a current account, a bank must have a specific contractual provision to rely upon if it intends to combine balances in these circumstances. It is perfectly possible for a bank to combine the balances in deposit accounts with those in current or loan accounts but to do so it must enter into a separate contractual arrangement with the customer. Therefore, the right of set-off in such circumstances would be a contractual rather than a Common Law right and the extent of the right would depend on the express contractual terms. An Irish case touching on this point is in *Re Euro Travel, Dempsey v Bank of Ireland.*[8] In that case the bank in question used the following form of wording in its standard letter of set-off signed by the customer:

> "Furthermore you are authorised to set-off and apply any monies or any part thereof from time to time in or towards the satisfaction of such liabilities entirely at your discretion, without further notice to us and we agree that such set-off would be a good and valid discharge of such monies so applied without the necessity of any further endorsement or authorisation from us whatsoever"

It may be worth mentioning that in Ireland it seems clear that the insolvency of the depositor is not necessarily fatal to the exercise by a bank of a contractual right of set-off. This could significantly improve a bank's position vis-à-vis liquidation in that a liquidator would acquire title to the assets subject to the pre-existing and enforceable right to combine balances.[9]

The Common Law right cannot be relied upon to combine accounts held by the customer in different capacities. Therefore, if a bank is aware, irrespective of how it gained the knowledge, that one account is operated by a customer as a trustee, whereas a second account is operated by the same customer in his personal capacity, the two accounts cannot be combined. This is due to the lack of mutuality between the parties in circumstances where the money in one account does not beneficially belong to a customer. Thus, it cannot be used to reduce the customer's liability without the consent of the beneficial owner of the funds. A bank that is not on notice that an account contains trust funds, cannot use the credit balance in one current account to reduce a debit balance in another account as per the normal operation of the Common Law set-off rule. Care should, however, be exercised where one account is designated as being something other than a current account. This would be all the more important if a bank was aware that the customer occupied a fiduciary status (e.g. stockbroker, solicitor, intermediary etc).[10]

The Common Law right will not apply where the credit balance in a current account concerns monies advanced by a bank for a specific purpose, where, firstly, that bank was aware of this specific purpose and, secondly, the purpose in question has not yet been achieved. In essence it has been held that a form of trust arises in these circumstances, known as a quistclose trust because of the case where the UK Courts first considered the issue.[11]

A bank cannot rely on the common law right if it has entered into an express agreement with its customer that it will not combine the customer's accounts. An agreement not to combine the customer's accounts may be terminated by a bank giving notice of its intention to exercise a right to combine. Although there appears to be no Irish authority on the point, English cases suggest that notice by a bank in such circumstances could take immediate effect. The House of Lords appears to have recognised that if even a reasonable period of notice was required, it would give the customer the opportunity to withdraw funds from the account thus defeating the purpose behind the banker's right of combination.

[6] See also *Garnett v McKewan* [1872] LR 8 EX 10.
[7] *Op.cit.*
[8] [1963 - 1993] *Irish Company Law Reports* 207 (1984).
[9] See Donnelly at 552.
[10] See Laffoy J's decision in *Money Markets International; Kavanagh v Murtagh* [2000] 3 IR 437.
[11] *Quistclose Investments Ltd. v Rolls Razor Ltd.* [1970] A.C. 567;

A bank may not set-off one customer's credit balance against the debit balance of another customer; the judgment of Fitzgibbon J. in *Bank of Ireland v Martin* is authority for this rule. As Fitzgibbon J. said in the Supreme Court:

> "...whatever rights a banker may have to combine two accounts of the same customer, there was no attempt to exercise any such right in the present case."[12]

Joint Accounts

We have already seen that under the Common Law a bank does not have an entitlement to set off one customer's credit balance against the debit balance of another customer. Although there does not appear to be any jurisprudence in Ireland on the issue, commentators have discussed the right of set off in the context of joint accounts. In *Banking Law in the Republic of Ireland*, Breslin offers the following view:

> "There are difficulties involved if the bank were to set-off a credit balance on a joint account against a debit balance on the personal account of one of the parties. It is said that this may be possible where the mandate of the joint account holders enables one party to debit the account. But this ignores the fact that it is the bank which is debiting the account, not the joint account holder. The other party to the joint account could have a claim for breach of contract if his money were used to reduce the debit balance of the other party". (At page 186)

The Common Law right of set-off would not permit a credit institution to transfer a credit balance from a joint account to satisfy a debit balance in an account maintained by one of the joint account holders. If a bank wanted to exercise that right, it could only do so if there was a clear written contractual term giving it such authority. It is likely that such a term would be so onerous as to make it essential for the contractual term to be specifically brought to the attention of the joint account holders at the time the original account was opened. It is hard to read the Unfair Terms in Consumer Contract's Regulations in any other fashion. A contractual term included in a bank's standard terms and conditions to allow the transfer of funds from a joint account to pay off debts by either account holder would likely to be struck down as constituting an unfair contractual term within the meaning of the Regulations. This is because the effect of the term would be to create a significant imbalance in the parties' rights and obligations as it effectively makes one account holder the guarantor of the other's debts without providing any of the information a guarantor would usually receive.

If the above constraints are borne in mind a bank may operate a right of set-off, even without any express agreement with a customer and in the absence of any written terms or conditions. Ultimately the right of set-off is the matching of chose in action by a bank and its customer. In the absence of a written condition expressly authorising the exercise by a bank of a right of set-off, without prior notice and without the necessity to seek further authorisation from a customer, then a customer may discover that he has good reason to resist set-off if the Common Law rules are exceeded. Equally, if a bank wants to extend its right of set-off to cover accounts other than current accounts or transfers from a joint account, a written contractual term would probably be necessary.

The reasons for making explicit and including even the basic right of set-off in contract are as follows. Unlike a right found in statute, the Common Law right of set-off has evolved as a result of decisions handed down by Courts over many years. By virtue of the doctrine of precedent, there is relative but not absolute certainty about the extent of the right. It has to be acknowledged and emphasised that each of the decided cases ultimately turned on its own facts. For example, although the authorities indicate that, generally, a bank is not under any obligation to give notice to its customer of an intention to combine current accounts, one could quite easily imagine a judge of the Irish Circuit or High Court deciding that, in a particular case, a bank should have given written notice of, say, that bank's intention to exercise the right of set-off and to combine the balances in current accounts with immediate effect.

If an individual suffers embarrassment at the public counter of a fictitious department store when she is unable to effect a purchase (as the funds in a particular current account have been combined with a debit balance in another account without notice) the possibility for defamation exists. Had her bank protected itself before combining the balances by giving written notice to the customer that this was being done with immediate effect the risk would be greatly reduced.

As Breslin makes it clear in his first edition, the Courts have stressed that the right of set-off is based on the contract between a bank and its customer. He goes on to suggest that, if the foregoing is the correct basis for the Common Law right of set-off:

"it is open to question whether any implied right to combine accounts survives the Unfair Contract Terms Regulations where the customer is a consumer".

The Minister for Enterprise and Employment enacted the European Communities (Unfair Terms in Consumer Contracts) Regulations, 1995.[13] Under these Regulations an "unfair term" in a contract "shall not be binding" on a "consumer". The definition of consumer under the Regulation is "a natural person who is acting for purposes which are outside his business".

The terms of the 1995 Regulations that are particularly relevant to the right of set-off are the following terms:

"(i.) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;

(j.) enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract;

[12] *Op. cit.* 204.
[13] SI No. 27 of 1995.

(k.) enabling the seller or supplier to alter unilaterally without a valid reason any characteristics of the product or service to be provided".[14]

The foregoing Regulations make it clear that unfair terms in consumer contracts include terms, which have the object or effect of "...irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract". Breslin argues that an implied right to combine accounts, i.e. the common law right of set-off, could be construed as an unfair term within the meaning of the 1995 Regulations. One could certainly envisage a situation where a consumer class of banking customer raised the 1995 Regulations before a Circuit Court Judge and argued that, prior to opening multiple current accounts, they had no awareness of or opportunity to become acquainted with the bank's right to combine balances. While such an argument has its frailties it remains stateable depending on the facts and in the absence of clear written terms brought to the attention of a consumer.

Missing documents and set-off; how do sections 38, 49 and 54 of the 1995 Consumer Credit Act assist consumer banking clients?

A credit agreement or guarantee must be concluded in writing (as per the 1995 Act). Section 38 of the 1995 Act clearly states that a creditor shall not enforce such a credit agreement unless the requirements in that Part of the Act[15] have been complied with. The section goes on to say that a Court may excuse a failure to comply with any requirements, other than section 30. The Court is required to satisfy itself that the failure was not deliberate and did not prejudice the consumer, and that it would be just and equitable. These requirements reflect the concept of 'fair procedures', as constitutionally guaranteed in the justice system of the State. Section 30 requires that the credit agreement and any contract of guarantee be made in writing. It does not address a situation where a credit agreement is entered into in writing and signed by both parties but subsequently lost. Nor does section 30 apply to credit in the form of advances on a current account or on credit card accounts. This is stated explicitly by section 30(4) of the 1995 Act. This is apparent from the definition of "credit agreement" in section 2 of the 1995 Act (an agreement whereby a creditor promises to grant to a consumer credit in the form of a deferred payment, a cash loan or other similar financial accommodation).[16]

Section 49 of the 1995 Act states that a person shall not make a demand for payment or assert a right to payment in relation to a credit agreement which is unenforceable under the Act and that a person shall not threaten to bring proceedings in relation to any unenforceable credit agreement.[17] Section 49 provides a defence for a person to show that he had reasonable cause to believe that there was a right to payment.

The reasonable cause referred to in section 49 (3) is a key point to understand. If a bank has a reasonable basis for believing that an original credit agreement complied with the provisions of Part III of the 1995 Act, it is submitted that the bank has reasonable cause to believe that there is a right to payment, despite the fact that the original credit agreement is lost.

Section 30(1)(a) of the 1995 Act requires a bank to hand a copy of any credit agreement to the customer or deliver it within 10 days. Unusually a bank might be faced with a deficiency of original records, decide to sue for its debt and then seek discovery from its erstwhile client in order to obtain a copy of the original document. A cynic might observe that it is unlikely that members of the public operate the document retention policies of major corporations. The unavailability of the credit agreement in the original could create practical problems but, it is submitted, it should not constitute an offence to make a demand for payment in respect of a credit agreement which has gone missing, so long as a bank has a reasonable basis for believing that the credit agreement was originally executed in writing and furnished to the consumer as required by the 1995 Act, e.g. scanned copies of the agreement on file.

Another difficulty presented by the absence of documentation underlying a consumer credit agreement is that of section 54(2)(e)(i) of the 1995 Act which requires "details of the agreement sufficient to identify it". The actual date of the agreement is not referred to but in light of the current proliferation of equity release products it might become increasingly necessary. It is conceded that an examination of this manner of consumer legislation is, in practice, somewhat Jesuitical and the likelihood of a licensed bank being prosecuted under the Consumer Credit Act 1995 is extremely small, however only a very confident man ignores the terms of the law or the deed.

[14] *ibid*. schedule 3.
[15] Part III.
[16] e.g. three thousand Ducats for three months.
[17] Section 12 of the 1995 Act makes this an offence possible of prosecution on indictment.