Name: Bernard David

Student No: DVDBER001

Degree: LLM (Commercial Law)

Supervisor: Associate Professor Graham Bradfield

Cash management for banks and set-off: A comparison of South African and English law

University of Cape

Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the LLM in Commercial Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to the length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Date: Signature:

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

University of Cape Town

TABLE OF CONTENTS

1. INTRODUCTION 1

1.1. Objective 1

1.2. Background 1

1.3. Reporting gross balances versus 'reduced' balances: cost implications 4

1.4. Definition 6

1.5. Structure of the dissertation 7

2. CASH MANAGEMENT IN SOUTH AFRICA: SINGLE ENTITIES 9

2.1. Introduction 9

2.2. Regulation 13 9

3. SET-OFF IN SOUTH AFRICAN LAW 11

3.1. Set-off at common law 11

3.2. Set-off by agreement 12

3.3. The commencement of insolvency 12

3.4. The prohibition against set-off on or after insolvency 13

3.5. Set-off prior to insolvency 15

3.6. Set-off: *Ipso iure* or retrospective? 19

3.7. The weight of authority 23

3.8. Retrospective operation of set-off: enforceable on insolvency? 26

3.9. Automatic operation of set-off *ex contractu*: enforceable on insolvency? 27

3.10. The South African Law Commission: Project 63 28

3.11. Set-off and cession 30

4. CASH MANAGEMENT IN ENGLAND: SINGLE ENTITIES 31

4.1. Introduction 31

University of Cape Town

4.2. Relevant regulations 31

5. SET-OFF IN ENGLISH LAW 34

5.1. The banker's right of set-off at English common law 34

5.2. Statutory set-off on insolvency 38

5.3. Set-off and assignment 46

6. CASH MANAGEMENT IN SOUTH AFRICA: MULTIPLE LEGAL ENTITIES .. 49

6.1. Introduction and regulation 13 49

6.2. Regulation 16 50

7. CASH MANAGEMENT IN ENGLAND: MULTIPLE LEGAL ENTITIES 53

8. CONCLUSION 54

APPENDIX I 55

APPENDIX II 56

APPENDIX III 57

APPENDIX IV 59

BIBLIOGRAPHY 60

University of Cape Town

Cash management schemes for banks and set-off - a comparison of South African and English law

1. INTRODUCTION

1.1. Objective

Cash management is used by banks' customers to optimise their interest income or expenditure. For prudential reasons relating to the calculation of reserves which a bank is obliged to hold, it is the subject of regulation in both South Africa and England. At the heart of certain types of cash management lies set-off, often referred to in banking terminology as 'netting'. The impact of the law of set-off in South African and English law on the respective countries' regulations will be explored in depth especially where insolvency law and set-off intersect.

1.2. Background

Banks are required by statute and regulations to hold certain minimum amounts of capital and reserves as part of their prudential requirements.[1] In this regard, banks must submit returns periodically containing certain of their financial particulars to the South African Reserve Bank ('SARB').[2] One such return is known as a Form 700 and permits the SARB to determine the extent to which a bank is meeting the Regulation's capital adequacy requirements. This form must be submitted on a monthly and a quarterly basis.[3]

Regulation 38(8)(*b*) provides:

> 'The percentage, contemplated in section 70 of the Act, *of the amount of a bank's assets and other risk exposures, as adjusted through the application of the relevant specified risk weights, proxies or factors*, and which is to be used, as contemplated in the said section of the Act, to calculate the minimum amount of allocated qualifying primary and secondary capital and reserve funds and tertiary capital that the bank is required to maintain in terms of that section shall be a minimum of 8 per cent, or such a higher percentage as may be determined by the Registrar in consultation with the Governor of the Reserve Bank, which

University of Cape Town

---

[1] Section 70 of the Banks Act 94 of 1990 ('the Banks Act'); Regulations relating to banks promulgated in terms of section 90 of the Banks Act, published in GNR 3 GG 30629 of 1 January 2008, the so-called 'Basel II regulations' ('the Regulations'), Regulation 38 (8) (*b*).
[2] The format and information required for each return is specified in the Regulations as a Form.
[3] Regulation 38 of the Regulations.

percentage or any relevant component thereof, amongst others, shall be inserted in items 1 to 3 and 17 to 22 of the form BA 700.' (emphasis added).

Debit balances represent claims the bank has against its client and are therefore assets. Since there is always the possibility that some of the bank's clients may default on loans advanced by the bank to them, these assets are risk weighted to reflect the probability of a client defaulting on a loan.[4] The current capital adequacy ratio is eight per cent. This implies that for every R100 the bank advances to a client, the bank must hold at least R8 in qualifying capital.[5] While the Form BA 700 is submitted on a monthly and quarterly basis, the monthly reports must reflect the average daily balances which are defined as the aggregate balance for the month divided by the number of days in that month.[6] It follows that when a bank has a debit balance (or loan) on a demand deposit account at close of business, it incurs a capital cost on the amount of that loan which it seeks to recover from the client. A portion of the interest charged on this debit balance is the capital cost incurred by the bank.

With traditional bank accounts, a debit balance represents a personal right the bank has against the customer for repayment of the balance and a credit balance represents a personal right that the customer has against the bank for repayment of the balance. These rights are personal in nature as real rights (i.e. ownership) in the cash passes to the client (in the case of a loan made by the bank to the client) or to the bank (in the case of a deposit made by the client).[7]

Where the client holds one bank account with a bank, the balance on the account represents a debt between the bank and the client. But where the client holds multiple bank accounts with the same bank, some of which are in credit and others in debit, do these balances still represent separate and distinct debts between the bank and the client? It is possible that the debit and credit balances are nothing more than accounting entries in the bank's books of accounts, that the separate accounts were created solely for the convenience of the client and that the balances on the accounts therefore do not represent separate and distinct debts between the bank and the client. Rather, the balances on the separate bank accounts are accounting entries relevant only for

University of Cape Town

[4] 'The Banker's Guide to the Basel II Framework' published by the Banking Association of South Africa (compiled by P Styger and PG Vosloo) (2005) accessed at http://www.banking.org.za/getdoc/getdoc.aspx?docid=848 on 30 March 2012 para 2.1.1 & 2.2.3.2.5.

[5] For the sake of simplicity, risk weighting has been ignored in this example as has the different types of qualifying capital and their definitions.

[6] Regulation 8 (1) of the Regulations.

[7] *Dantex Investment Holdings (Pty) Ltd v National Explosives (Pty) Ltd (in liquidation)* 1990 (1) SA 736 (A) at 748G-H.

the purposes of calculating the general running balance (ie the net amount of the account balances) which represents the only debt obligation between the bank and the client.[8]

In order to determine whether balances on multiple banks accounts held by a client with its bank represent separate and distinct debts between them or that the balances are merely accounting entries not giving rise to separate debts is a matter of the parties' intention.[9] However, where the parties' intention cannot be ascertained, either expressly or tacitly, what is the default position which is implied by law? This debate has evidently not been finally resolved in English law[10] and the position is uncertain in South African law.[11]

It is submitted that, absent the intention of the parties, the balances on the various bank accounts represent separate and distinct debts between the bank and its customer. Where a client holds one account with the bank, that account represents a debt between the bank and the client. It seems logical that by opening a second account, the balance on the new account should, in the absence of a contrary indication by one of the parties, follow the same principle. Moreover, if regard is had to everyday parlance, customers evidently share this understanding as well. For example, a customer will refer to accounts with credit balances as being accounts with cash in them even though ownership in that cash vests in the bank (for example, 'I have R100 in account no. 1') and similarly refer to accounts with debit balances as being a separate loan owed to the bank (for example, 'I owe the bank R75 on my overdraft on account no. 2'). Customers transact on bank accounts as though they are assets (for example, 'I am depositing another R200 in account no. 1) or liabilities (for example, 'I withdrew another R10 on my overdraft. I now owe the bank R110 on account no. 2'). Whatever might be implied by law, the Regulations presuppose that balances represent debts between the bank and its customers (hence the general rule that will be discussed shortly that balances must be reported on a gross basis). For the purposes of this dissertation (unless otherwise stated), it will be assumed that balances on multiple bank accounts represent separate and distinct debts between a bank and its customer.

University of Cape Town

---

[8] Mark Hapgood *Piaget's Law of Banking* 12 ed (2002) para 29.14.; *Halesowen Presswork & Assemblies Ltd v Westminster Bank Ltd* [1970] 3 All ER 473,CA at 488b.

[10] E P Ellinger, Eva Lomnicka and C V M Hare *Ellinger's Modern Banking Law* 5 ed (2011) 252: based on current leading authorities, the bank's right to combine accounts is to be regarded as a right of set-off.

Under the Regulations these balances must be reported to the SARB as gross balances unless otherwise stated.[12] In other words, the bank is obliged to report a customer's aggregate debit balances separately from its aggregate credit balances - the general rule does not permit the bank to deduct debit balances from credit balances. The 'reduction of balances', which permits a balance other than a gross balance to be reported, may be effected in the limited ways prescribed. These are by the application of set-off in terms of regulation 13, cash-management schemes in terms of regulation 16 or netting in terms of the relevant requirements specified in regulation 23. Of these, only set-off in terms of regulation 13 and cash management scheme in terms of regulation 16 are relevant.

1.3. Reporting gross balances versus 'reduced' balances: cost implications

Where a client holds more than one bank account with the same bank, the accounts typically have a mix of debit and credit balances at close of business. Reporting such accounts on the basis of gross balances means reporting a client's aggregate debit balances separately from its aggregate credit balances. This basis of reporting results in the client earning less interest from, or paying more interest to (as the case may be), the bank than would be the case if the aggregate of debit balances were notionally set-off against or actually consolidated with the aggregate of credit balances.[13] This pricing differential is illustrated by the comparison contained in Appendix I (scenario: aggregate debit balances exceed aggregate credit balances) and Appendix II (scenario: aggregate credit balances exceed aggregate debit balances).

Thus, if a bank is able to comply with regulation 13, it may report the net position (i.e. the difference between aggregate debit and aggregate credit balances held by a particular client) and it need only hold reserves on the basis of this net position. The saving in the cost of capital to the bank allows the client to optimise their interest income or expenditure (as the case may be).

The discussion so far has been limited to a single client's bank accounts with a bank. The benefit of consolidating balances of various bank accounts can also be extended to multiple companies which are members of the same group of companies.[14] In this scenario, one of the companies in the group earns or is charged interest (as the case may be) on the net balance for the participating companies in the group.[15] The group of companies is then free to decide how

University of Cape Town

[12] Regulation 9(1) of the Regulations.
[13] This is what regulation 9 (2) contemplates as a '*reduction of balances*'.
[14] This is the definition of '*cash-management scheme'* contained in regulation 65 of the Regulations.
[15] Not all group companies necessarily participate in the cash management scheme.

this interest income or expense will be allocated within the group. Although this involves multiple companies, the principles set out above (including those illustrated by the tables in appendices I and II) apply equally in a group setting.

Methods of achieving this consolidation (whether at single entity or group entity level) lie at the heart of cash management as practiced by banks. It is useful, when analysing and describing cash management schemes, to classify the schemes and the level at which they operate. Two useful distinctions can be drawn.

- Single entity versus multiple legal entities (or group companies) cash management: the level at which a cash management scheme operates.
- Notional pooling versus actual pooling schemes: whether the scheme (at single entity or multiple legal entity level) notionally creates a net position or actually transfers or pools (sometimes referred to as *'sweeping')* funds between various bank accounts and/or entities.

In the light of the obvious implications that such schemes have for the holding of capital reserves, it is not surprising that they are dealt with in the Regulations. As noted above, the Regulations make it quite clear that, in general, reporting must be made on the basis of gross balances and that there are two exceptions to this rule.

The first exception applies to single legal entities only and is a notional pooling system based on a legal right of set-off held by the bank.[16] The most critical and difficult requirement (at least in South African law) is that the legal right of set-off must be enforceable on the insolvency of the bank or the client. The central bank wishes to ensure that on insolvency of the bank or the client, the solvent party is able to create a legal net balance representing a single claim (owing by the client to the bank or vice-versa) which cannot be challenged by the liquidator.[17] If set-off is invoked by the bank and the liquidator is able to successfully challenge it, the liquidator will be able to 'cherry pick' credit balances (i.e. demand repayment of the full amount owing by the bank to the liquidated client) whereas the bank would only have a concurrent claim for debit

University of Cape Town

[16] Regulation 13 of the Regulations.

[17] For the sake of brevity, the term *'liquidator'* will be used as will terminology related to winding up of companies. Unless otherwise indicated, any reference to a liquidator or a winding up includes a reference to a trustee or a sequestration.

balances (i.e. claims it has against the insolvent client). Should this occur, the bank may discover that it is holding inadequate capital reserves for these debit balance exposures.[18]

The second exception applies to group companies only and is an actual pooling system based on the actual transfers of balances between participating companies at the close of business of each day.[19] Although a number of different schemes can be established which would all comply with the Regulations, the typical cash management scheme for group companies has a company (often but not always the holding company) which acts as a centralising company to which all the other companies' balances are transferred and concentrated. The effect of these transfers is to create intercompany loans between the centralising company and the other companies and to reduce or increase the gross balances of such other companies' to zero.[20] In other words, the credit and debit balances of all bank accounts in the group are transferred to and consolidated in the centralising company which earns or is charged interest on its consolidated balance (which is the consolidated position for the participating group companies).

The most significant requirement for cash management for multiple legal entities is that the scheme is limited to companies within the same group and may not be extended to arrangements between other entities such as trusts, close corporations or natural persons.

1.4. Definition

The term 'cash management scheme' is statutorily defined as 'an agreement between a bank and such of its clients as are members of the same group of companies in respect of which group annual financial statements are required to be completed in terms of the provisions of section 228(1) of the Companies Act, which agreement provides for transfers of balances between such clients' accounts kept in the accounting records of the bank, and which transfers are made in order to minimise the interest expense or to maximise the interest income of such clients.'[21] This definition is, however, narrow and does not reflect the everyday usage of the term by bankers

University of Cape Town

[18] In practice, a creditor with a concurrent claim against an insolvent company in liquidation usually receives a very modest dividend (if any).
[19] Regulation 16.
[20] Where the participating company has a credit balance with the bank, the balance is transferred to the centralising company by way of an intercompany loan. The nominated company becomes a debtor of the participating company and a creditor of the bank in relation to the balance transferred. Where the participating company has a debit balance, the balance is transferred to the centralising company by the centralising company lending the amount of the debit balance to the participating company (thereby creating an intercompany loan). The funding is either provided from the centralising company's available cash balances with the bank or borrowed from the bank.
[21] Regulation 65.

and their corporate clients. Their understanding of the term ‘cash management’ is far broader and can only be properly understood once the background to cash management has been sketched.

‘Cash management’ is not a term of art. For the purposes of this dissertation, cash management will be defined as any scheme or method adopted by the bank and its client or clients (where such clients are members of the same group of companies), the objective of which is the reduction of gross account balances, either notionally or actually, reported by the bank to the central bank for the purposes of maximizing interest income or minimizing interest expenditure for the client or clients.

1.5. Structure of the dissertation

This dissertation will therefore begin by analysing the arrangements for single legal entity cash management and the law of set-off in South African and English law. Multiple legal entity cash management will then be dealt with in greater detail as well as the regulatory framework of both South African and English law. Where relevant, the impact of set-off in South African and English law on cash management schemes for banks will be addressed.

Set-off usually refers to the discharge of reciprocal obligations between the same parties. It can occur automatically at common law or by agreement between parties. The parties may agree that it occur automatically on the occurrence of an event (such as an insolvency event) or that one of the parties may invoke set-off.[22] South African law does not permit set-off once insolvency has commenced. This rule is subject to statutory exceptions.[23] It will be argued that none of these exceptions are relevant to cash management. Since a critical requirement for single legal entity cash management is a legal right of set-off which is enforceable on insolvency, a key issue that will also be addressed is whether a right of set-off once exercised operates retroactively. If it operates retroactively, perhaps to a time before insolvency commenced, then set-off on insolvency may be permissible.

It will finally be argued that under current South African insolvency law it is impossible to comply with regulation 13 and that the Insolvency Act[24] should be amended to provide for a legally enforceable right of set-off on insolvency thereby accommodating notional pooling. It

University of Cape Town

[22] When by agreement, set-off can be multi-lateral and operate between more than two parties.
[23] Insolvency Act 24 of 1936, ss 35A and 35B.
[24] Act 24 of 1936.

will be further argued that notional pooling is simpler than and preferable to actual pooling for group companies.

Cross-border cash management schemes (also referred to as global liquidity management) falls outside the scope of this dissertation. It should be noted that there are important regulatory and tax implications for these schemes as their legal effect and consequences may differ across jurisdictions.

There are other legal issues pertaining to cash management which also fall outside the scope of this dissertation and are mentioned only in passing: compliance with s 45 of the Companies Act[25] to the extent that intercompany loans are created, the impact of business rescue under the Companies Act on set-off and cash management, the concept of the best interests of the company (especially in a group setting) and tax implications for group cash management schemes.

Legislation, case law and legal textbooks up to 30 April 2013 were considered when writing this dissertation.

University of Cape Town

[25] Act 71 of 2008.

2. CASH MANAGEMENT IN SOUTH AFRICA: SINGLE ENTITIES

2.1. Introduction

Cash management for banks in South Africa is governed exclusively by the Regulations promulgated pursuant to the Banks Act. For single legal entities, a reduction of balances (i.e. a departure from reporting gross balances to SARB) is only permissible if regulation 13 is complied with.

2.2. Regulation 13

Regulation 13 (entitled *'Set-off'*) reads as follows:

'13. Set-off

(1) When a client maintains both debit and credit balances with a bank, it may be permissible in certain circumstances to set such balances off against one another for the purposes of completing the prescribed forms, resulting in only net balances being reported.

(2) Unless specifically otherwise provided in these Regulations, set-off shall be allowed only if all of the circumstances specified below apply.

(a) A legal right to set-off shall exist, and the reporting bank shall in cases of legal uncertainty obtain a legal opinion to the effect that its right to apply set-off is legally well founded and would be enforceable in the liquidation or bankruptcy of the client or the bank.

(b) The debit and credit balances shall relate to the same obligor.

(c) Both the debit and credit balances shall be denominated in the same currency.

(d) The debit and credit balances shall have identical maturities.

(e) The reporting bank shall monitor and control the relevant debit and credit balances on a net basis in its risk management process and client database for the granting of facilities.

(3) For the purposes of this regulation 13, obligor means any natural person or juristic person, and 'person' shall not have the same meaning as a 'person' defined in regulation 65.'

Sub-regulation 13 (1) does not contemplate set-off in the legal sense of the term. Rather, a notional set-off is intended in terms whereof the aggregate of debit balances are deducted from the aggregate of credit balances for the purposes of reporting a net balance to SARB only. With notional set-off the separate claims by the bank against the client and vice-versa as represented by the various debit and credit balances remain intact and unaltered by the calculation.

University of Cape Town

Sub-regulations 13 (1) and 13 (2) (b) clearly limit the application of this regulation to single entities only. The entities may be natural or juristic.[26]

Currency risk and liquidity risk (which may result from a mismatch in tenor between debit and credit balances) are respectively dealt with in sub-regulations 13 (2) (c) and (d).

A bank's exposure when relying on regulation 13 (i.e. notional set-off) to a single entity is limited to the net position which is simply the difference between a client's debit and credit balances. In theory, it should be sufficient for the bank to enforce the net limit by ensuring that the difference between debit balances (monies drawn down) and credit balances does not exceed the net limit. In practice however, banks often lack automated systems that prevent a client from exceeding the net limit by either increasing debit balances and/or decreasing credit balances (by making payments during the course of the day) excessively. This risk, which arises from technological and systems limitations, is addressed in sub-regulation 13 (2) (e). The practical measures that a bank may implement to give effect to this sub-regulation are two-fold:

- On-going monitoring of the client's account conduct to ensure that it remains within the net limit; and
- Creating a gross limit for debit balances. A bank's systems may only be able to enforce gross limits automatically- once a gross limit has been loaded on the system, no human intervention is required to ensure its effectiveness. This protects the bank from potentially massive excesses which a client can generate. In a worst-case scenario even if the client pays away all its credit balances the bank's exposure will never exceed the gross limit.[27]

The final and critical requirement is sub-regulation 13 (2) (*a*): the enforceability of the legal right of set-off on the insolvency of the bank or the client. This issue will be addressed in some depth.

University of Cape Town

[26] Regulation 13 (3) of the Regulations.

[27] This is referred to as a gross-net limit. For example, gross-net facility limit of R100 and R70 respectively means that a client's aggregate gross debit balances may not exceed R100 (irrespective of its credit balances) and its net utilisation of the facility (i.e. aggregate debit balances less aggregate credit balances) may not exceed R70.

3. SET-OFF IN SOUTH AFRICAN LAW

3.1. Set-off at common law

Common law set-off (*compensatio)* involves the discharge of mutual debts between two persons. This occurs by means of the one debt being set-off against the other. The result may be that both debts are completely discharged or, where one debt is larger than the other, the larger debt is reduced by the amount of the smaller debt.[28] The theoretical nature of set-off is uncertain: it should not be characterised as a 'reciprocal cancellation' of the mutual debts or as a form of payment (although its effect may be the same as payment) because no agreement to set-off is required.[29]

The persons must be mutually indebted in their personal capacities. Thus, where one person owes a debt in their personal capacity and the other in a representative capacity, set-off cannot occur.[30] Both debts must be liquidated and due and payable[31]. However, where a debt is due but either the creditor or the law affords the debtor additional time within which to pay it, the debt is considered due and payable for the purposes of set-off.[32] Thus in *Van Pareen v Pareen's Properties (Pty) Ltd*[33] the managing director of a company had drawn a cheque for £75 in his favour on the company's bank account. After resigning his directorship and selling his shares in the company, he was sued by the company for the amount of the cheque. He argued that at the time he had drawn the cheque, the company had been indebted to him in the amount of £2,000 and that a portion of this amount had been set-off against the amount of the cheque. The company countered that set-off could not have occurred because in the absence of a fixed time for repayment, the company was entitled to a reasonable period of time to repay. The shareholder's loan may therefore have been due but it was not enforceable. The court held that 'the most that can be said in favour of the contention [the company's argument] is that the company might have been entitled to a period of grace after demand for repayment of the loan.

---

[28] L T C Harms 'Obligations' in WA Joubert (founding ed) *The Law of South Africa* vol 19 2 Ed (2006) para 243; *Schierhout v Union Government (Minister of Justice)* 1926 AD 286 at 289-90.
[29] S van der Merwe, L F van Huysteen, M F B Reinecke & G F Lubbe *Contract General Principles* 3 ed (2007) 546; but see *Joint Municipal Pension Fund (Transvaal) v Pretoria Municipal Pension Fund* 1969 (2) SA 78 (T) at 86A where it was stated that set-off is 'a payment effected *brevi manu*'; J W Wessels *The Law of Contract in South Africa* vol II 2 ed (1951) paras 2559 & 2578: set-of operates a 'reciprocal double payment'.
[30] Ibid; D J Joubert *General Principles of the Law of Contract* (1987), p 286
[31] Harms op cit para 243 (c); *Roman Catholic Church (Klerksdorp Diocese) v Southern Life Association Ltd* 1992 (2) SA 807 (A) at 814I.
[32] Wessels op cit para 2560.
[33] 1948 (1) SA 335 (T).

University of Cape Town

But the fact that either the creditor or the law allows a period of grace does not prevent the operation of *compensatio*.[34]

The performances due under both debts must be of *eiusdem generis* (of the same kind). Thus, mutual claims sounding in money are capable of set-off but not a claim sounding in money and a claim for the delivery of a thing.[35]

Parties are able to contract out of common law set-off and agree, either expressly or tacitly, that their individual claims will not be subject to set-off.[36] For example, it has been held that where two companies simultaneously exchange cheques on a monthly basis to settle their respective indebtedness instead of crediting each other, they had expressly or at the very least tacitly agreed that set-off would not operate in respect of their mutual debts.[37] It is submitted that the debit and balances on bank accounts held by a customer at the same bank are an illustration of this principle. The bank, to protect its interests, may obtain a contractual right to set-off the balances at any time or in specified circumstances (such as the occurrence of defined events of default).

3.2. Set-off by agreement

Parties who have excluded common law set-off from operating by agreement may also agree that mutual debts will be set-off upon the occurrence of a certain event (such as an event of default) or at the discretion of one of the parties. It is submitted that this should not be confused with common law set-off as the source of common law set-off is *ex lege* whereas an right of set-off created by an agreement is *ex contractu*. The relevance of this distinction will become evident when the issue of set-off on or after the commencement of insolvency is discussed below.

3.3. The commencement of insolvency

In the case of a sequestration insolvency commences when the court grants the provisional order of sequestration.[38] Liquidations however are deemed to commence at the time of the presentation to the court of the winding-up application providing that a provisional liquidation order is subsequently granted.[39] It has been held that the time of the presentation of a winding-up application to the court is when the application has been lodged with the registrar of the court in

[34] Ibid at 339.
[35] Van der Merwe *et al* op cit 548.
[36] *Southern Cape Liquors (Pty) Ltd v Delipcus Beleggings BK* 1998 (4) SA 494 (C) at 501B-D.
[37] *Herrigel NO v Bon Roads Construction Co (Pty) Ltd and another* 1980 (4) SA 669 (SWA) at 676A & 676H.
[38] Catherine Smith *The Law of Insolvency* (1982) 136-137.
[39] Act 61 of 1973, s 348.

University of Cape Town

its proper form.[40] For brevity sake, the commencement of both liquidation and sequestration will be referred to as the commencement of insolvency.

Additionally, case law on sequestration is relevant to the law of liquidations and vice-versa. This is in no small part due to section 339 of the previous Companies Act which applies the law relating to insolvency (i.e. sequestrations) *mutatis mutandis*, in so far as they are applicable, in respect of any matter not specially provided for by that Act.[41] For the sake of convenience, the term 'insolvency' when used in this dissertation will denote both sequestrations and liquidations unless the contrary appears.

3.4. <u>The prohibition against set-off on or after insolvency</u>

On the commencement of a liquidation or a sequestration, a *concursus creditorum* is created. This crystallizes the position of the insolvent and its creditors and 'thereafter nothing can be entered into with estate matters by a single creditor to the prejudice of the general body'.[42] Once this has occurred a creditor may not do anything that will alter the rights of the other creditors.[43] The claim of each creditor must be dealt with as it existed at the commencement of insolvency.[44] The objective of this rule is to ensure that concurrent creditors are treated *pari passu* and that no one concurrent creditor should be preferred in its claim above another.

Thus, contractual stipulations which on insolvency confer a preference to certain concurrent creditors will not be given effect to. In *Administrator, Natal* v. *Magill, Grant and Nell* (*Pty.*) *Ltd.* (*In Liquidation*)[45] the contractor had agreed with the employer to erect a building. In terms of the contract, progress payments were to be made with the final payment to be made after the issue of the certificate of final completion. Clause 21(b) of the contract entitled to the employer, prior to making any payment to the contractor, to request that the contractor furnish it with reasonable proof all nominated sub-contractors' account had been paid. If the contractor was in default in respect of a payment to a nominated sub-contractor, the employer could elect to pay the nominated sub-contractor directly and deduct such payment from any amount due by the

---

[40] M S Blackman 'Companies' in WA Joubert (founding ed) *The Law of South Africa* vol 4(3) First Reissue (2006) para 164, fn 1.
[41] Para 9 of the Fifth Schedule to Act 71 of 2008 provides for the continued application of certain provisions of Act 61 of 1973 which deal with the winding-up of companies on the basis that they are unable to pay their debts.
[42] *Walker v Syfret NO* 1911 AD 141 at 166.
[43] *Thorne (supra)* at 222. It is submitted that what is objectionable is not altering the rights of other creditors (technically a creditor cannot alter the content of another creditor's right) but rather obtaining a preference over other concurrent creditors.
[44] *Walker v Syfret, N.O.* 1911 AD 141 at 160.
[45] 1969 (1) SA 660 (A).

University of Cape Town

employer to the contractor. The clause also provided that any exercise by the employer of this power would not create 'a privity of contract' between the employer and the nominated sub-contractor.[46]

Prior to the contractor's liquidation, the building was completed and certain progress payments (save for the final payment) were made to the contractor. After liquidation it appeared that two nominated sub-contractors had been short-paid by the contractor. The employer elected, as it was entitled to do in terms of the contract, to pay amounts owing to the contractor directly to the nominated sub-contractors and sought, in accordance with the contract, to deduct these payments from the amount it owed to the liquidator.[47] The court held that although the employer had validly exercised its election under clause 21(b) of the contract, it could not permit the deduction of these payments from the amount owed to the liquidator on the grounds that:

> '…the exercise of that election after liquidation had supervened disturbed both the realisation and the distribution of the plaintiff company's assets as prescribed by the law relating to liquidations. Were this Court now to uphold the validity of the election exercised by the defendant . . ., *the door would be opened to contractual stipulations expressly designed to accord, on insolvency or liquidation, preference to selected creditors who would otherwise be merely concurrent*.'[48] (emphasis added).

Set-off may only operate before the establishment of the *concursus creditorum* and unless all the requirements for set-off have been satisfied prior to this time there may be no set-off.[49] This principle is illustrated by the facts in *Thorne* (supra). A contractor had agreed to render building works at three sites and entered into three separate contracts with the government. Work at the three sites commenced but prior to completion of the contracts the contractor was placed in liquidation. The creditors of the contractor then resolved that the insolvent contractor was to perform its obligations under only two of the contracts and that work on the third contract was to be abandoned. As a result of the contractor's repudiation of the third contract, the government suffered damages which were quantified as liquidated damages. It sought to set-off (or 'deduct') these damages from amounts it owed the contractor on the two completed contracts on the basis

---

[46] Ibid at 668A-F.
[47] Ibid at 668G-669A.
[48] Ibid at 672B-C.
[49] *Thorne and another, NNO v The Government* 1973 (4) SA 42 (T) at 45F-G and the cases cited there including *National Bank v Cohen's Trustee* 1911 AD 235 at 249; *The Government v Thorne and another, NNO* 1974 (2) SA 1 (A) at 9E-G; *Roman Catholic Church* supra at 815A-D.

University of Cape Town

of a contractual provision which entitled the government to deduct liquidated damages from any amounts 'due or to become due' under that contract or any other contract between the contractor and the government.[50] It was held that the government could not set-off debts that had arisen after the commencement of liquidation: the contractor's right to payment to payment under the two performed contacts had accrued after the commencement of the liquidation, and the government's claim for liquidated damages had only been 'ascertained' after liquidation had commenced. It is submitted that what the court meant in using the word 'ascertained' was 'caused' or 'arose'.[51]

In view of the above, it is evident that set-off of balances on accounts which are due but not yet payable, such as fixed deposits, may never be set-off on or after the commencement of insolvency. As the tenor of the debit and credit balances must be identical,[52] the discussion of set-off and insolvency in this dissertation will be limited to debit and credit balances on current accounts that are repayable on demand.

3.5. Set-off prior to insolvency

Set-off prior to the commencement of insolvency is dealt with by s 46 of the Insolvency Act.[53] It provides that if insolvency commences within six months of the set-off being effected, the trustee may abide the set-off. In the case of set-off of a debt which was ceded, the time period is one year. However, if the set-off occurred during the respective time periods other than in the ordinary course of business, the trustee may with the approval of the Master disregard the set-off. The trustee may then claim the full amount of the creditor's debt owed to the insolvent, while the insolvent's claim would rank concurrently with the body of creditors.

Although s 46 is not applicable to set-off which takes place between an exchange and a market participant in terms of s 35A or in accordance with an agreement contemplated by s 35B of the Insolvency Act, it is submitted that these sections are of no relevance to the set-off of balances on bank accounts. Section 35A deals with transactions on an exchange which is defined as an exchange licensed in terms of the Securities Services Act.[54] Section 35B deals with master agreements providing for termination and netting. A master agreement is defined as:

---

[50] Ibid at 43H-44B.
[51] Ibid at 45H-46A.
[52] Regulation 13(2)*(d).*
[53] Act 24 of 1936.
[54] Act 36 of 2004.

University of Cape Town

‘*(a)* an agreement in accordance with standard terms published by the International Swaps and Derivatives Association, the International Securities Lenders Association, the Bond Market Association or the International Securities Market Association, *or any similar agreement*, which provides that, upon the sequestration of one of the parties-

(i) all unperformed obligations of the parties in terms of the agreement-

(aa) terminate or may be terminated; or

(bb) become or may become due immediately; and

(ii) the values of the unperformed obligations are determined or may be determined; and

(iii) the values are netted or may be netted, so that only a net amount (whether in the currency of the Republic or any other currency) is payable to or by a party,

and which may further provide that the values of assets which have been transferred as collateral security for obligations under that agreement shall be included in the calculation of the net amount payable upon sequestration; or

(b) any agreement declared by the Minister, after consultation with the Minister of Finance, by notice in the *Gazette* to be a master agreement for the purposes of this section.’[55] (my emphasis).

A question which arises from this definition is whether a bank and a client could conclude a master agreement that provides for the termination of balances on bank accounts held by the client with the bank and the netting (ie set-off) such balances to arrive at a net amount. It would be a straightforward matter to include the provisions required by subparas (i) to (iii) of the definition. However, in order to qualify as a master agreement, the agreement would have to be a ‘similar agreement’ to those that are listed. Standard agreements published by the International Swaps and Derivatives Association, the International Securities Lenders’ Association, the former Bond Market Association or the former International Securities Market Association deal with financial instruments such as swaps, derivatives and securities lending.[56] It seems fair to conclude that the types of financial instruments and products that are envisaged by the definition of a master agreement do not extend so far as to include balances on bank accounts.

University of Cape Town

[55] Sub-sections 35B(2)*(a)-(b)*.

[56] *Nichol v Burger* 1990 (1) SA 231 (C) at 237H: set-off is equivalent to payment.

This interpretation is reinforced if one has regard to the legislative history of s 35B and comments made by the South African Law Commission on the section.[57] Prior to amendment[58] the section heading was 'Agreements on informal markets' and s 35B(1) defined such an agreement as any agreement providing:

> '…primarily for delivery, exchange, settlement or payment…on a future date, of, or in connection with, or based on, or based on the price of, currency of a country other than the Republic, interest rates, exchange rates, indices, gold, precious or base metals, financial instruments … securities …or such other commodity or corporeal or incorporeal thing or agreement as may be specified by the Minister, after consultation with the Minister of Finance, by notice in the *Gazette*, or any combination of, or option on, any of the aforegoing agreements.'

The types of transactions forming the subject matter of s 35B self-evidently do not include the set-off of balances on bank accounts.

Two further aspects of s 46 are noteworthy. First, it appears that set-off is premised to operate automatically and *ipso iure* the moment the requirements for it have been met.[59] Secondly, there is a paucity of case law on the 'in the ordinary course of business' qualification within the context of s 46. To give content and meaning to the expression, recourse must be had to the case law where the same phrase is used in connection with impeachable transactions, more particularly s 29(1) which deals with voidable preferences).

In determining whether a transaction can be said to have taken place 'in the ordinary course of business' involves an objective test; the ordinary business person must enquire whether ordinary, solvent business persons would in the normal course of business act in the manner that the debtor and the insolvent did.[60]

De Villiers JP formulated the test as follows:

> '...whether the disposition is in accordance with ordinary business methods and principles obtaining *amongst solvent men of business*, that is to say a disposition, in order to be in the

[57] South African Law Commission Discussion Paper 86 (Project 63) *Review of the Law of Insolvency* vol 1 (2000) para 28.3. It is evident from the discussion that the intention of s 35B was to limit its application to special types of agreements only such as derivatives and swaps.

[58] 55 of 2003.

[59] De Wet & Yeats op cit 283 note 174; BVD van Niekerk 'Some thoughts on the problem of set-off' (1968) 85 *SALJ* 31 at 37; Van der Merwe *et al* op cit 551 note 260.

[60] *Hendriks v Swanepoel* 1962 (4) SA 338 (A) at 342H; Bertelsman, Eberhard; Herbert, Walter; Evans, Roger G; Harris, Adams; Kelly-Louw, Michelle; Loubser, Anneli; Roestoff, Melanie; Smith, Alastair; Stander, Leonie; Steyn, Lee & Nagel, CJ (editor) *Mars The Law of Insolvency in South Africa* 9 ed (2008) 262.

University of Cape Town

ordinary course of business, must be one which would not to the ordinary man of business *appear anomalous or unbusinesslike or surprising'*.[61] (emphasis added).

It follows that the fact the one party to the transaction is insolvent is irrelevant to the test and must be disregarded. A person, even if their liabilities exceed their assets may operate their business in a normal, ordinary manner in the hope that its fortunes will improve and it will return to solvency. And if the effect of such a normal, ordinary transaction is that one creditor is preferred above another then that too is irrelevant.[62] All the relevant circumstances surrounding the transaction including any custom or usage specific to an industry must be considered[63] along with the actions of both parties, not just the insolvent.[64] It is submitted that in essence the test is attempting to identify either an abnormality in the means or manner which the transaction was carried out (for example, unnecessary or circuitous steps) or that the terms and conditions of the transaction were not those that would be expected of transaction between solvent business persons acting reasonably.

Two crucial questions arise at this juncture. First, does set-off operate *ipso iure* and automatically when its requirements for mutual debts have been met? As mentioned in the introduction to this dissertation, it will be assumed that the debit and credit balances on a customer's bank accounts are separate and distinct debts- this may be by agreement between the bank and the customer or possibly implied by law. While the balances on the accounts remain separate set-off would not occur. The bank, in order to protect its interests, would therefore need to enter into an agreement providing for the automatic operation of set-off on the insolvency of the customer. This is turn would raise the issue of whether a set-off effected pursuant to such an arrangement would be in the ordinary course of business or fall foul of the *pari passu* principle.

Secondly, if set-off does not operate automatically but operates retrospectively (ie the set-off occurs in relation to mutual debts that existed a moment prior to the commencement of insolvency), would an election exercised after the *concursus creditorum* had come into being be valid? Surely it could be argued that, notwithstanding that the creditor made their election after insolvency has commenced, the set-off was retrospective to a time prior to the insolvency's commencement and that it therefore was 'effected' (to use the terminology of s 46) prior to the

[61] *Malherbe's Trustee v Dinner* 1922 OPD 18 at 22.
[62] De la Rey loc cit.
[63] *Estate Wege v Strauss* 1932 AD 76 at 85 where Wessels ACJ described the relationship between a bookmaker and his client as a 'special kind of business'.
[64] Ibid 128.

University of Cape Town

insolvency's commencement? Assuming that in the vast majority of cases such a set-off would have occurred within six months of insolvency commencing, the issues of whether such a set-off was effected in the ordinary course of business or violated the *pari passu* principle would also need to be addressed.

3.6. Set-off: *Ipso iure* or retrospective?

It is unclear whether set-off operates automatically and *ipso iure* from the moment all its requirements are met in relation to the reciprocal debts or whether it must be claimed or invoked by one of the parties and is retrospective in operation. There is case law supporting both possible legal positions.[65]

In *Schierhout (supra)* Innes CJ held that:

> '….. one debt extinguishes the other *pro tanto* as effectually as if payment had been made. Should one of the creditors seek thereafter to enforce his claim, the defendant would have to set up the defence of *compensatio* by bringing the facts to the notice of the Court --- as indeed the defence of payment would also have to be pleaded and proved. But, compensation once established, the claim would be regarded as extinguished from the moment the mutual debts were in existence together.'[66]

This *dictum* is ambiguous and has been interpreted to support the view that set-off operates *ipso iure* and the view that its operation is not automatic but must be claimed and operates retrospectively.[67] Numerous cases, before and after *Schierhout (supra)*, have contained conflicting *dicta* on this point.[68]

Legal writers also disagree on this issue and advance arguments for and against both positions. Joubert opine that the Roman-Dutch writers favoured the view that set-off operates automatically once its requirements have been satisfied.[69] The defendant who pleads set-off must prove that all its requirements were met and that it took place but such a defendant is not exercising a right of set-off but merely proving a historical juristic event. The learned author also argues that the 'balance of convenience' favours that set-off operate automatically. To adopt the

---

[65] Harms op cit para 245; De Wet & Van Yeats op cit 273, 281-82; Van der Merwe et al op cit 551-552; Joubert op cit para 21.3.3.

[66] Loc cit.

[67] For example, in *Southern Cape Liquors* supra the case of *Schierhout* supra was cited in support of the position that set-off operates automatically and *ipso iure* (at 500F-H). A contrary view was expressed in *Hardy NO & Mostert v Harsant* 1913 TPD 433; *Bain v Barclays Bank* 1937 SR 191 at 203-204.

[68] Harms op cit note 14 of para 245 and the cases cited therein.

[69] Joubert op cit para 21.3.2 and 21.3.3 (p 288); *cf* De Wet & Yeats op cit 282 who state this was 'mostly' ('meestal') the view of the Roman-Dutch writers.

University of Cape Town

alternative view requires introducing the fiction of retrospective operation of set-off which may have practically undesirable effects. To illustrate his point, he provides the following examples. A defendant, who is being sued for a breach of contract which he or she committed, would be able to nullify the breach by invoking set-off. Or consider the defendant who owes interest on an outstanding debt (i.e. the interest as already accrued) and who is able to retrospectively wipe out the interest by claiming set-off. Similarly, any steps taken by the creditor to obtain redress against the defaulting party for the breach of contract would also be nullified. Such an approach 'would raise immeasurable difficulties for the creditor who would not know what course the defendant would take.'[70]

In a similar vein to Joubert's argument, it has been argued that retrospective set-off could materially alter the financial position of the creditor: assets which had hitherto existed would restrospectively vanish from the creditor's balance sheet or the creditor may have to repay any amounts paid to it by the debtor (such as interest) prior to the retrospective set-off.[71] The creditors of the creditor may also suffer prejudice as a result of a retropsective set-off.

Consider the example of a term loan, which contains a cross-default clause as an event of default, advanced by a bank to a borrower. The borrower defaults on its obligations to make payment to a supplier thereby constituting an event of default. Relying on this event of default, the bank accelerates all amounts outstanding under the loan and institutes proceedings against the borrower for repayment of the amounts advanced. At the same time, the supplier has also instituted proceedings to recover the amounts owed to it by the borrower who raises set-off in its plea (we will assume that the other requirements of set-off have been satisfied). If set-off operates retrospectively, then the default never occurred, the event of default was not triggered and the bank's acceleration of the amounts owing by the borrower are a nullity. In short, the bank's entire cause of action is retrospectively wiped out and the bank may find itself saddled with a nasty costs order.

It is submitted that this line of argument loses sight of the fact that if the defendant is able to claim set-off (with retrospective effect), then so too could the creditor (the plaintiff). If the creditor was in the dark as to the course the defendant would take, then it would be in the

[70] Joubert op cit para 2.3.3 (p 289).
[71] Christiana Fountoulakis *Set-off Defences in International Commercial Arbitration. A Comparative Analysis* (2011) 212.

University of Cape Town

creditor's power to remove any uncertainty by simply claiming set-off. This rebuttal though does not address situations where the plaintiff does not elect to claim set-off to the possible detriment of its third party creditors.

Another policy based argument is advanced by Van Niekerk who argues that automatic set-off helps establish with greater precision the moment when set-off occurs thereby enhancing certainty, that it promotes efficiency as debts are settled at the earliest possible time and that it avoids a multiplicity of actions.[72] However, as pointed out by Van der Merwe *et al* invoking set-off with retrospective effect will not necessarily lead to less certainty or a multiplicity of actions.[73] Irrespective of whether set-off operates *ipso iure* or must be exercised by one of the party's with retrospective effect, the procedural requirements and evidentiary burden will be identical; the party seeking to place reliance on set-off will need to plead set-off and prove that the requirements for its operation had been satisfied. While recognising that the earliest possible extinction of debts might serve a valid public interest, Van der Merwe *et al* identify a countervailing and important consideration: the need to recognise the autonomy of the parties in regard to relying on set-off.[74] This need, it is argued, outweighs whatever public interest there may be in the earliest possible extinction of debts. It is submitted though that it is open to parties to agree that the operation of set-off between mutual debts will not apply and thereby attain their autonomy in this manner. Freedom of contract effectively grants parties the power and the freedom to create this autonomy should they so wish.

The learned authors also point out that even if set-off operates automatically it remains open to a party to exercise an election: they can choose to either rely on set-off or deny or ignore that set-off has occurred, pay their debt and then claim the payment owing to him or her. This qualification '…recognises the autonomous decision of the party who makes the election as an indispensable element for the operation of the rule, and tends to undermine the notion of automatic operation and reduce it to a theoretical construction.'[75] Of course, that party runs the risk that when claiming payment, the debtor may rely on set-off in which case they may be able to recover their payment using the *condictio indebiti*.[76]

University of Cape Town

---

[72] Van Niekerk op cit 36.
[73] Van der Merwe op cit 551.
[74] Ibid 552.
[75] Ibid.
[76] Ibid 551 note 263; *Southern Cape Liquors* supra at 501C-D.

One of the elements comprising the cause of action for this *condictio* is that the payment must have been made in error (which may be a mistake of law or fact)[77] and that the mistake was excusable.[78] The courts have refrained from defining what constitutes an excusable mistake:

> 'It is not possible nor would it be prudent to define the circumstances in which an error of law can be said to be excusable or, conversely, to supply a compendium of instances where it is not. All that need be said is that, if the payer's conduct is so slack that he does not in the Court's view deserve the protection of the law, he should, as a matter of policy, not receive it. There can obviously be no rules of thumb; conduct regarded as inexcusably slack in one case need not necessarily be so regarded in others, and vice versa. Much will depend on the relationship between the parties; on the conduct of the defendant who may or may not have been aware that there was no *debitum* and whose conduct may or may not have contributed to the plaintiff's decision to pay; and on the plaintiff's state of mind and the culpability of his ignorance in making the payment. (Consider, for example, the case of a person who, whilst in doubt as to whether money is legally due, pays it not caring whether it is and without bothering to find out.) These are only a few considerations that come to mind; others will no doubt manifest themselves with the passage of time as claims for the recovery of money paid in error of law come before the Courts.'[79]

By electing to deny or ignore that set-off has occurred, the party is assuming the risk of it being subsequently held that set-off did in fact occur. They might then be precluded from recovering their payment by means of the *condictio indebiti* because the mistake they made in exercising their election was inexcusable. By way of illustration, suppose A sells a car to B for a purchase consideration of R10. B renders services to A for an agreed amount of R15. B denies that set-off has operated, pays A the purchase price of R10 and then claims R15 from A. Assuming set-off has indeed operated, B will have a claim for R5 (being the outstanding amount after set-off operated) and a claim for R10 on the basis of the *condictio indebiti*. However, unless B can prove that his or her denial of set-off's operation amounted to an excusable mistake, their claim on the basis of the *condictio indebiti* will fail.

It follows that the 'autonomy' to exercise an election is constrained by this very real risk. Assuming a party is satisfied that the requirements of set-off have been met, it would be ill-

[77] *Willis Faber Enthoven (Pty) Ltd v Receiver of Revenue* 1992 (4) SA 202 (A) at 224C; *Affirmative Portfolios cc v Transnet Ltd t/a Metrorail* 2009 (1) SA 196(SCA) para [37].
[78] Ibid at 224D.
[79] Ibid at 224E-G *per* Hefer JA.

University of Cape Town

advised and foolhardy of them to deny or ignore this, make payment of the amount owing by them and then claim payment for the other amount owing to them.

The debate as to manner in which set-off operates also has implications for set-off in the context of co-debtors whose liability is joint and several. Where a creditor claims the whole performance from such a co-debtor (as such a creditor is entitled to do), that co-debtor may rely on set-off should the creditor be indebted to them.[80] But may a co-debtor rely on set-off in relation to a debt owed by the creditor to another co-debtor but not to them? If set-off operates automatically, the logical answer is in the affirmative; if co-debtors A and B are jointly and severally indebted to C in the sum of R100 and C is indebted to A in an equal amount, then the joint and several debt is cancelled by way of set-off and either A or B should be able to rely on set-off. However, as noted by De Wet & Yeats, Voet takes a contrary view.[81] This implies that set-off does not operate automatically and must be claimed by the person to whom the debt is owed.

Conversely, where there are joint and several co-creditors and one of the co-creditors claims the full performance against the debtor, may the debtor rely on set-off in relation to a debt owed by the other co-creditor to the debtor? Once again, if set-off operates automatically the logical answer must be in the affirmative. Yet, Voet still takes a contrary view.[82]

It is submitted that Voet's views on these issue are incorrect as they are wholly irreconcilable with his express statement that the plea (or 'declaration') of set-off 'does not wipe out the obligation, but notifies that it had already been previously been wiped out'.[83] This is an unequivocal statement by Voet that set-off operates automatically. His opinions on set-off in the context of joint and several debtors and creditors are therefore puzzling.

3.7. The weight of authority

The majority of the Roman-Dutch writers favour the view that set-off operates automatically once its requirements have been satisfied. Christie expresses the view that the 'the overwhelming weight of authority' maintains that set-off is automatic and has to be pleaded and proved 'only to

University of Cape Town

[80] J C de Wet & A H van Wyk *Die Suid-Afrikaanse Kontraktereg and Handelsreg* 5 ed (1992) 275-76 citing J Voet *Commentary on the Pandects* 16.2.7. For the purposes of the example it will be assumed that all the other requirements for set-off have been satisfied.
[81] Ibid.
[82] Ibid; Voet loc cit.
[83] *The Selective Voet being the Commentary on the Pandects by Johannes Voet* (translated by Percival Gane) vol 3 (1956) 16.2.2.

inform the court that is has occurred.'[84] This is consistent with the comprehensive review of the case law in *Great North Farms (Edms) Bpk v Ras*[85] and the relatively recent decision of *Southern Cape Liquors (supra).*[86] Although Van der Merwe *et al* advocate that set-off should be claimed by a party and operate retrospectively, they also state that weight of judicial authority favours set-off operating automatically and *ipso iure* and that this also appears to have been the position in Roman-Dutch law.[87] They are also of the view that s 46 of the Insolvency Act was drafted on the basis that set-off operates automatically and *ipso iure.*[88]

In the recent case of *The Standard Bank of South Africa Ltd v Echo Petroleum cc*,[89] the Supreme Court of Appeal had the opportunity to resolve the debate about whether set-off operates automatically or operates retrospectively from the time it is claimed. Unfortunately, for the reasons that follow, this opportunity was squandered. The case involved a substantial sum of money deposited by the respondent into the bank account of one S ('the 602 account') which was held with the appellant bank. S held another account with appellant ('the 253 account') which had a debit balance. The bank had demanded payment of this outstanding amount in June 2008 but it was only on 2 October 2008, after the respondent had deposited the moneys into the 602 account, that the bank appropriated these moneys and applied them in partial reduction of the debit balance on the 253 account.[90] The respondent sought to vindicate the moneys deposited on the grounds that the funds were earmarked for petroleum products that it had purchased from S and that ownership in the moneys would only be transferred to S once it had taken delivery of the products. The court rejected this argument.

The respondent also contended the bank had been unjustly enriched and took the point that although the bank had demanded repayment of the 253 account during June, it had not appropriated the credit on the 602 account until 2 October. During this period the credit balance on the 602 account had fluctuated and, so it was argued, the bank ought to have made a fresh

University of Cape Town

---

[84] RH Christie & GB Bradfield *The Law of Contract in South Africa* 6 ed (2011) 494.
[85] 1972 (4) SA 7 (T).
[86] A discussion and analysis of the case law, Roman-Dutch authorities and textbook writers can be found at 499E-501D.
[87] Van der Merwe op cit 551.
[88] Ibid note 260.
[89] 2012 (5) SA 283 (SCA).
[90] Ibid paras [9]-[10], [21]-[23].

demand for repayment on 2 October before relying on set-off.[91] Hefer JA rejected this argument which the learned judge of appeal described as 'wholly artificial' for the following reasons:

> 'The debt arising on the 253 account was never discharged and the demand stood. Although set-off occurs automatically by operation of law, it only operates, retrospectively, if and when the debtor (the Bank) elects to rely on it. See *Southern Cape Liquors (Pty) Ltd v Delipcus Beleggings Bpk* 1998 (4) SA 494 (C) at 499I-501D and the authorities there cited. That election only took place on 2 October at a time when the 253 account remained unpaid and subject to the unsatisfied demand.'[92] (my emphasis).

The *dictum* is confusing because it seems to suggest that set-off operates both automatically by operation of law *and* retrospectively from the time that the debtor elects to rely on it. Not only is this conceptually and logically impossible but it is contrary to what was held in *Southern Cape Liquors (supra)* which the court cited as authority for this proposition. Perhaps what is meant by the term 'retrospectively' is that the court recognised that the set-off had already occurred during June 2008 ie in retrospect the set-off had automatically occurred in June 2008. Indeed, this seems to be the only sensible construction of Hefer JA's statement. It is unfortunate that this statement was not formulated in a less ambiguous fashion.

Whatever the correct interpretation may be, the judgement is also problematic because the balances on both accounts ought to have been set-off as at June and *not* as at 2 October. Although the judgement does not state what the account balances were when demand was made in June 2008, it seems quite possible that the balance on the 602 account may have been materially less during June 2008 than on 2 October 2008.[93] And if the set-off had taken place during June, why did the bank continue to keep the two accounts segregated?

It is also unclear whether this statement is merely an *obiter dictum* or amounts to the *ratio decidendi*. The court found that the respondent had not laid a foundation for a claim based on unjust enrichment.[94] In the absence of such a foundation, it is submitted that it was unnecessary for the court to consider whether the bank had acted lawfully in appropriating the credit. To the extent that the court did so, its ruling on this point might be considered *obiter.*

[91] Ibid para [32].
[92] Ibid para [33].
[93] Ibid para [23].
[94] Ibid para [34].

University of Cape Town

In sum, the law on this critical issue has yet to be definitively settled with clarity. Until such time as this legal question is settled by the Supreme Court of Appeal not only would it be imprudent for South African banks to rely on Regulation 13 to reduce balances for reporting purposes but, in the light of the legal certainty, it would be impossible for a bank to 'obtain a legal opinion to the effect that its right to apply set-off is legally well founded and would be enforceable in the liquidation or bankruptcy of the client or the bank.'[95]

3.8. <u>Retrospective operation of set-off: enforceable on insolvency?</u>

Assuming, for arguments sake, that the Supreme Court of Appeal does settle this debate in favour of retrospective operation of set-off, would set-off by a bank of the balances on its customer's accounts on or after its customer's insolvency be legally enforceable?

At first blush, it appears that such a set-off would not do violence to the *pari passu* principle. The set-off would operate retrospectively to a time just prior to the creation of the *concursus creditorum*. Both mutual debts would have been due and payable prior the commencement of insolvency and all the requirements for set-off would have been met (unlike cases such as *Thorne (supra)* and *Roman Catholic Church (supra)* where the debts either did not arise or become payable until after insolvency).

However, there may still be contravention s 46 of the Insolvency Act. Although set-off would have been 'effected' when the set-off of the mutual debts actually occurred (prior to the insolvency's commencement), the actual set-off cannot be divorced from the election to claim it. In other words, the set-off is linked to and is the result (albeit the retrospective result) of such an election. It is submitted that the word 'effected' must be given a broader meaning so as to include the election to claim set-off. Otherwise, the requirement in s 46 that set-off be in the ordinary course of business would surely be rendered meaningless.

In this regard, it is unlikely that set-off can be considered to have been effected in the ordinary course of business. A solvent customer's overdraft with a bank is not normally repaid by means of the bank setting-off amounts to the credit of the customer in other accounts. The customer will either pay funds into the overdraft account from other sources (for example, cheque deposits) or transfer funds from an account with a credit balance to the overdraft account. The bank might only exercise such a right of set-off where the customer's overdraft is in excess or where the bank wishes the client to settle the overdraft and the client refuses to do so. The test

[95] Regulation 13 (2) (*b*).

University of Cape Town

as to whether set-off has occurred in the ordinary course of business requires us to ignore the fact that the customer is insolvent. If we do so, then the bank's exercise of its right of set-off would strike the ordinary businessperson viewing this transaction objectively as unusual and abnormal.

3.9. Automatic operation of set-off *ex contractu*: enforceable on insolvency?

A final possibility to consider is a *contractual* provision which triggers set-off on the insolvency of one of the contractants. If the bank, in order to protect its interests, entered into an agreement providing for the automatic operation of set-off on the insolvency of its customer, would such a set-off be legally enforceable. Technically, there would be no need for the bank to make an election or do anything for set-off to occur; set-off would be triggered by the insolvency commencing. It should be emphasized that we are not dealing with common law set-off which may operate automatically

The difficulty with this approach is that it amounts to a contractual stipulation designed to prefer the bank over the customer's other creditors. An automatic contractual set-off on insolvency would amount to the bank effectively using the credit balances the bank owed to the insolvent customer to pay (and thereby settle) the debit balances. *Dicta* to the effect that set-off is a form of payment (although incorrect for the reasons given by Van der Merwe *et al*)[96] have been interpreted to mean that set-off has the same effect as payment.[97] This would be contrary to the *pari passu* principle.

It might be argued that the bank and the customer could have achieved the same economic effect as automatic set-off in insolvency if they had agreed that the balances on the customer's accounts did not constitute separate and distinct debts between the bank and the customer but were merely accounting arrangements for the customer's convenience. In other words, it would have been possible for the parties to have ordered their affairs in a different legal manner while retaining the same economic effect as set-off. However, the simple point is that the parties did not arrange their affairs in such a manner. They agreed that the gross balances would represent separate and distinct debts between the bank and the customer and that set-off would only operate on the customer's insolvency. Thus, it is unlikely that this argument would succeed.

It therefore appears that irrespective of whether set-off operates retrospectively once claimed or contractual provision is made for it to operate automatically on insolvency, it will not

---

[96] Van der Merwe op cit note 225 at 546.
[97] Ibid referring to *Nichol* supra at 237.

University of Cape Town

be enforceable on or after insolvency. There remains the possibility of statutory reform to the insolvency regime, which will now be addressed.

3.10. The South African Law Commission: Project 63

The main piece of legislation which governs insolvency law in South Africa is the Insolvency Act.[98] Although it has been amended numerous times, it has not since its commencement in 1936 undergone a comprehensive review. It was against this background that the South Africa Law Commission was tasked with reviewing the Insolvency Act and proposing a draft Bill of a new Insolvency Act.[99] Clause 28 of the draft Bill reads as follows:

> '28(1) Subject to the provisions of subsection (2) in this section 'agreement' means-
>
> (a) an agreement which provides that, in the event of the estate of a party thereto or the estate of a party to two or more agreements with the same counterparty, being liquidated before such party has performed fully in terms of the agreement or one or more of the agreements;
>
> (i) all unperformed obligations of the parties terminate or may be terminated; and
>
> (ii) the termination values of the unperformed obligations are determined or may be determined; and
>
> (iii) the termination values are netted or may be netted, so that only a net amount (whether in South African currency or some other currency) is payable to or by a party; or
>
> (b) any agreement declared by the Minster after consultation with the Minister of Finance, by notice in the Gazette to be an agreement for the purposes for this section.
>
> (2) In this section 'agreement' does not include-
>
> (a) transaction contemplated in section 27; or
>
> (b) netting arrangement as contemplated in the National Payment System Act, 1998 (Act No. 78 of 1998); or
>
> (c) any agreement declared by the Minster after consultation with the Minister of Finance, by notice in the Gazette to not be an agreement for the purposes of this section

[98] Act 24 of 1936.

[99] South African Law Commission Discussion Paper 86 (Project 63) *Review of the Law of Insolvency* (1999).('SALC: Insolvency Review'), p 12.

University of Cape Town

(3)[100] Upon the liquidation of the estate of a party to an agreement all unperformed obligations arising out of such agreement or all such agreements between the same parties shall, notwithstanding any conflicting rule of the common law, automatically be terminated as at the date of liquidation, termination values being calculated at market value at that date and a net amount be payable.

(4) Section 341 (2) of the Companies Act, 1973 (Act No. 61 of 1973) shall not apply to property disposed of in terms of an agreement.'

Suppose a bank and its customer were to enter into an agreement governing debit and credit balances held at the bank which complies with all the requirements of clause 28(1)(a). The agreement merely has to provide that upon either the bank or its customer being liquidated before the bank has been able to repay all credit balances and the customer has been able to repay all debit balances, these unperformed obligations will terminate, the value of these unperformed obligations will be determined as being their face value when denominated in the same currency or the bank's spot rate at the time of the liquidation where a claim is denominated in a different currency, and the termination values will be netted (i.e. set-off against each other leaving a single net amount owing by the bank to the customer or vice-versa).

Such an agreement would also not be a transaction contemplated by clause 27 (a transaction on an exchange) nor would it be a netting arrangement as contemplated in the National Payment System Act.[101]

In the event of either the bank or its customer being liquidated, clause 28(3) would have to give effect to this agreement and 'notwithstanding any conflicting rule of the common law' all obligations arising from such agreements would be terminated as at the date of liquidation, termination values calculated at market value at that date and the net amount payable. In other words, clause 28 creates a right of set-off which arises *ex contractu* (assuming the contract qualifies as an agreement as defined) which is enforceable on insolvency.

It is questionable whether this was the intention behind the drafting of the clause and that the literal wording of the clause gives rise to a far wider range of transactions than was contemplated by the South African Law Commission. To the extent that clause 28 was intended by the Commission to be a re-enactment of s 35B, it seems likely that it was contemplated by the

[100] The sub-section is incorrectly numbered in the draft bill as sub-section (2). The same is true of sub-section (4) that follows.
[101] Act 78 of 1998.

University of Cape Town

drafters that clause 28 was to be limited to the netting and termination of financial instruments and not extend to netting debit and credit balances on bank accounts.

Nevertheless, the Commission did observe that clause 28 was 'clearly not limited to informal markets'[102] and on a literal reading of the clause, a right of set-off enforceable on insolvency could be created via a suitably tailored contract. It remains to be seen if and when the existing Insolvency Act[103] will be replaced, the precise formulation of clause 28 and the manner in which it will be judicially interpreted.

3.11. <u>Set-off and cession</u>

The relationship between set-off and cession depends on a number of factors including timing and notice to the debtor of the cession. Where the reciprocal debts are due between the cedent and the debtor and assuming set-off occurs automatically, the debtor may not raise set-off against the cessionary as the cedent cannot transfer a greater right than it itself possesses.[104] The same rule applies where the debt fell due after the cession had taken place but before the debtor had notice of it.[105] The rationale for this rule is, it is submitted, that it would be unfair to the debtor, who has not received notice of the cession and has relied on set-off, to be deprived of it.[106] Where a debt is ceded which is not yet due and only becomes due after notice to the debtor of the cession has been given, the debtor may not raise set-off as a defence against the cessionary as the necessary reciprocity of due debts did not exist prior to notice of the cession having been given to the debtor.[107]

It would therefore be a prudent for a bank to provide in its standard terms and conditions that debts owing by the bank to the customer may not be ceded without the consent of the bank first being obtained.

University of Cape Town

[102] SALC: Insolvency Review at 80, para 28.5.
[103] Act 24 of 1936.
[104] Christie & Bradfield op cit 498; *Walker v Syfret* 1911 AD 141 at 159 and 162.
[105] Christie & Bradfield loc cit; *Clark v Van Rensburg* 1964 (4) 153 (O) at 161-162; *Agricultural and Industrial Mechanisation (Vereeniging) (Pty) Ltd v Lombard* 1974 (3) SA 485 (O) at 494G-H.
[106] Clark supra at 161A; *Agricultural and Industrial Mechanisation* supra at 496 C-F.
[107] Christie & Bradfield loc cit. *Oudtshoorn Town Council v Smith* 1911 CPD 558 at 560.

4. CASH MANAGEMENT IN ENGLAND: SINGLE ENTITIES

4.1. Introduction

Bank supervision and regulation in England is the responsibility of the Financial Services Authority ('FSA'),[108] which was created in terms of and derives its powers from the Financial Services and Markets Act ('FSMA').[109] The FSA has rule making powers, which permit it to make rules that apply to regulated activities[110]as defined in the Regulated Activities Order made by the Treasury.[111] Since 'accepting deposits' by way of business is a regulated activity, the FSA can and has made rules regulating UK banks.

The power conferred on the FSA to make rules is exercisable in writing and these written instruments (defined as 'a rule-making instrument)[112] are contained in FSA's Handbook.[113] Since s 153(4) obliges the FSA to publish a rule-making instrument in a way appearing to it to be best calculated to bring it to the attention of the public, the entire FSA Handbook is available on the FSA website.[114]

4.2. Relevant regulations

The portion of the FSA Handbook that deals specifically with banks is the Prudential sourcebook for Banks, Building Societies and Investment Firms. The FSA designated acronym for this handbook is BIPRU.

The relevant section of the BIPRU that addresses 'on balance sheet netting' is BIPRU 5.3,[115] which is reproduced in Appendix III hereto. At this point, it may be instructive to distinguish between the technical use of the terms set-off and netting. Set-off is a legal technique; netting is a process of which set-off may be a part. Although set-off is the most common technique used in the netting process, this is not necessarily the case.[116]

University of Cape Town

---

[108] Ellinger, Lomnicka & Hare op cit 33.
[109] 2000 c. 8.
[110] Part X Chapter I of the FSMA.
[111] Ellinger, Lomnicka & Hare op cit 34.
[112] Sections 153(1)-(2) of the FSMA.
[113] Ellinger, Lomnicka & Hare op cit 40.
[114] FSA Handbook available at http://fsahandbook.info/FSA/index.jsp accessed on 11 December 2012.
[115] Instead of referring to sections or articles in the BIPRU, references to a section or article x will be to BIPRU x. This is in keeping with the FSA handbook method of citation.
[116] The Interim Prudential sourcebooks for Bank (last day in force 30 October 2010) available at http://fsahandbook.info/FSA/html/handbook/IPRU-BANK/-link- accessed on 11 December 2012. IPRU-BANK Chapter NE section 3.4 available at http://www.fsa.gov.uk/pubs/cp/cp52a2.pdf accessed on 11 December 2012.

In order to be eligible for on balance sheet netting the claims between the firm (*in casu* the bank) and its counterparty (the customer) must be mutual i.e. there must be a reciprocity of obligations between the same parties.[117] The reciprocal obligations are limited to cash balances (i.e. the right of repayment of cash deposited or loaned by one party to the other).[118]

Expressly excluded from the ambit of BIPRU 5.3 are master netting agreements covering repurchase transactions, securities or commodities lending or borrowing transaction and other capital market-driven transactions.[119] These agreements or transactions are dealt with elsewhere in BIPRU: master netting agreements in BIPRU 5.6 and contractual netting in BIPRU 13.7.

BIPRU sets out four minimum requirements for on balance sheet netting. First, the on balance sheet netting agreements must be legally effective and enforceable in all relevant jurisdictions and in the event of the insolvency or bankruptcy of a counterparty.[120] Second, the bank must be able to determine at any time the loans or deposits that are subject to the on balance sheet netting agreement.[121] Thus, the bank's systems should be able to provide the value of the reciprocal obligations subject to the on balance sheet netting agreement at any time of the day in a single currency. This can be quite challenging where the cash balances are comprised of different currencies which need to be converted at the spot rate in order to ascertain the net position of the bank and its customer. Third, where this form of credit protection (the ability to net reciprocal obligations) terminates (for example, due to the insolvency of the counterparty), the bank must be able to respond quickly and prevent further transacting on the basis of netting as to do so could prejudice the bank. Thus, the bank must ensure that the risks associated with such a termination are adequately monitored and controlled.[122] Fourth, (4) the bank must monitor and control the relevant exposures on a net basis.[123] A bank's systems must be able to ascertain the net exposure in respect of a customer at any time and controls should be put in place that will prevent that net exposure from exceeding the net limit imposed on the customer. This can be quite challenging if the bank systems lack the ability to automatically enforce a net limit but must rely on intermittent human monitoring of the net exposure. In such a scenario, one method

University of Cape Town

---

[117] BIPRU 5.3.1.
[118] BIPRU 5.3.2.
[119] BIPRU 5.3.3.
[120] BIPRU 5.3.3 (1).
[121] BIPRU 5.3.3 (2).
[122] BIPRU 5.3.3 (3).
[123] BIPRU 5.3.3 (4).

to mitigate the risk of the customer exceeding the net limit (for example, by paying away credit balances during the course of the day thereby exceeding the net limit) is to mark a gross overdraft limit as well. If the bank's systems can automatically enforce such a gross limit on an overdraft, then the worst case scenario for the bank (for example, where the customer pays away all of its credit balances) will be the overdraft's gross limit. Although not ideal, this does go some way to mitigating and limiting the risk of the net limit being exceeded. For illustrative purposes, suppose the bank marked a gross limit on the overdraft of R100 and a net limit of R60. In the morning the customer holds credit balances of R70 and is overdrawn in the amount of R100. It is therefore well within its net limit. Should the customer for whatever reason pay away all of its credit balances, the bank's gross exposure will never exceed R100 (being the gross overdraft limit which its systems can automatically enforce).

Finally, loans and deposits with a bank must be treated as cash collateral.[124] This has two consequences: it recognises that on balance sheet netting is a form of credit risk mitigation and that the loans and deposits are encumbered by the netting agreement and may therefore not be used as collateral for any other purpose.

University of Cape Town

[124] BIPRU 5.3.4.

5. SET-OFF IN ENGLISH LAW

5.1. The banker's right of set-off at English common law

Also referred to as the banker's right to combine accounts or consolidate accounts, the right is analogous to but must not be confused with the banker's right of lien.[125] This right of set-off allows a bank to combine separate accounts of its customer and arrive at a net balance. The terms right of set-off, right to combine accounts and right to consolidate accounts will be used interchangeably.

A useful distinction that can be drawn is between a current (or trading) account and loan account. A current account is used for daily transactional purposes and must be kept in credit whereas a loan account is used to record monies advanced by the bank to the customer.[126] It is well established that the bank has the right to combine two current accounts unless there exists a contrary agreement between the bank and the customer. [127] However, where the bank permits a customer to maintain both a current account and a loan account, it has been held that it is an implied term of such an arrangement that the bank will not combine the two accounts.[128] In order to combine such accounts the bank would have to clearly retain that right in its agreement with the customer. The implied term which prevents a banker from combining a current account and a loan account may cease to be operative in certain circumstances thereby allowing the bank to combine such accounts.[129]

This is illustrated by the case of *Halesowen* (supra). The customer held an account with the bank which was overdrawn in the amount of £11,339 ('no. 1 account'). The bank was extremely concerned about this debit balance and meetings were held and correspondence was exchanged between the parties in an attempt to remedy this outstanding amount. According to the customer's accountant, if the customer's business was to be sold as a going concern the bank would be repaid the full amount; however if the customer's assets were to be realised at a forced sale only a portion of the bank's claim would be settled. The customer had opened a new transactional account with another bank as it feared that any cash which flowed into the no. 1

---

[125] Hapgood op cit 601; Ellinger op cit 251.

[126] This is in accordance with the meaning of the terms in *Halowen* (supra) at 652. It is of course possible for the bank and the customer to agree that a current account may have an overdraft limit.

[127] Hapgood op cit 602-603; *Halesowen* supra at 477f-h.

[128] *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] 1 All ER 641, HL at 652j-651b. To avoid confusion between the judgement of the court of appeals and that of the House of Lords, the former will be cited as *Halesowen CA* (supra) and the latter as *Halesowen HL* (supra).

[129] Hapgood op cit 604.

account would be utilised for the permanent reduction of the outstanding balance leaving the customer with insufficient funds to continue its business operations. It was therefore agreed between the parties that the no. 1 account would be frozen and that the customer would move its transactional account which was in credit to the bank ('no. 2 account'). This account would always be kept in credit and the bank would only be entitled to use the funds standing to the customer's credit in the no. 2 account for paying any charges and interest (on the no. 1 account). Thus, the no. 1 account was a loan account and the no. 2 account a current/trading account. This arrangement would remain in place until the customer sold the business or liquidated its assets within four months or if there arose 'materially changed circumstances'.[130]

Approximately one month after this arrangement was put in place, the customer notified the bank that a meeting of creditors would shortly be held to consider the winding up of the company. It was common cause that this notification constituted materially changed circumstances which would have entitled the bank to terminate the arrangement. Despite this notification, the bank permitted the customer to continue to trade using the no. 2 account. On the morning of the creditors' meeting (which took place later that afternoon), a cheque drawn in favour of the customer in the amount of £8,611 was deposited at the bank and credited to the no. 2 account. At the creditors' meeting it was resolved that the customer should be placed in liquidation. The bank then sought to rely on the banker's right of set-off and to set off the amount owing on the no. 1 account against the balance on the no. 2 account (which was in credit due largely to the cheque that had been deposited that morning).[131] The bank contended that it was owed the resulting balance by its customer (in liquidation). The liquidator saw things differently and contended that the bank was not permitted to set-off or combine the two accounts. It accordingly instituted legal proceedings against the bank to recover the amount of the cheque (which had been credited to the no. 2 account).[132]

The liquidator was unsuccessful in the court a quo which held that the bank had not agreed to refrain under any circumstances from setting-off any balance on the no. 2 account against the amount owing under the no. 1 account.[133] On appeal to the court of appeals, it was held by Lord Denning MR that there was such an agreement but that the giving of notice to the bank of the

University of Cape Town

---

[130] *Halesowen, CA* supra at 475.
[131] Ibid at 476e-f.
[132] Ibid at 476g.
[133] *Halesowen Pressworks & Assemblies Ltd v Westminster Bank Ltd* [1970] 1 All ER 33 (the court a quo).

meeting of creditors to be held constituted a material change in circumstances. This entitled the bank to terminate (or 'determine') the arrangement on the giving of reasonable notice to the customer (per Lord Denning MR). Winn LJ agreed that the bank had not terminated the arrangement but refrained from expressing a view as to the period of notice. The judges of appeal were unanimously of the view that since bank had not given any notice before combining the two accounts, it was not entitled to do so. The majority of the court accordingly allowed the appeal. Buckley LJ held that immediate notice may have sufficed provided the bank honoured cheques drawn up to the time of receipt of notice. His lordship otherwise dissented and dismissed the appeal on different grounds that were unrelated to the omission to give notice, namely that the two accounts constituted 'mutual' debits and credits as contemplated by s 31 of the Bankruptcy Act, 1914 (as applied by the s 317 of the Companies Act, 1948) and the set-off of mutual debits and credits was mandatory under that Act. Any agreement to the contrary was overridden by this statutory set-off. This issue will be more fully explored when the impact of legislation on the right of set-off is dealt with below.

In a further appeal to the House of Lords, the law lords generally refrained from expressing a view on the period of notice required. The exceptions were Lord Simon of Glaisdale who stated obiter that immediate notice may suffice provided the bank honoured cheques drawn up to the time of receipt of notice[134] and Lord Kilbrandon who questioned the very relevance of notice once insolvency had intervened.[135]

The House of Lords found for the bank on two grounds. First, the substratum of the agreement between the bank and the customer was to keep the customer trading as a going concern or to provide it with time to dispose of its assets profitably. It was never in the contemplation of the parties that the agreement would continue on the customer's insolvency because once insolvency had intervened neither of the two objectives could be realised. The agreement therefore terminated on the passing of the creditors' resolution to liquidate the customer and it was then open to the bank to combine the two accounts.[136] Second, even if this was not the case, s 31 of the Bankruptcy Act, 1914 was applicable. As mentioned above, this will be more fully explored below when statutory set-off is discussed.

[134] *Halesowen, HL* (supra) at 653e-g.
[135] Ibid at 662e.
[136] *Halesowen HL* (supra) at 651b – d, 654b-c, 655f, and 662c-f.

University of Cape Town

The right is subject to certain limitations and exceptions. The indebtedness in the accounts available for set-off must be due and payable. It is not permissible for a bank to set-off a debt that is due and payable in one account with a debt that is only payable in future in another account or a debt which is contingent in nature.[137]

There are three main exceptions to this right.[138] First, the right can be excluded by agreement, either implied or express, between the bank and the customer. As example of this is the *Halesowen* case (supra) which has just been discussed. Where two current accounts are denominated in different currencies the accounts should also be subject to the banker's right of set-off as holding different currencies in different accounts does not necessary imply that the banker's right of combination was to be excluded.[139] Where the bank accounts are held in different jurisdiction the position is more complicated. It must be ascertained whether the foreign jurisdiction laws of set-off apply and if so, whether they permit the banker's right of set-off.[140] It could be argued that it is implied that the right to set-off does not apply because foreign offices are often viewed as separate from the local bank. On the other hand, where a monies are deposited with a foreign office which fails to repay the customer, the customer can demand payment from the main local office. This may allow the main local bank to argue that the implied term is no longer applicable because the agreement not to combine has been terminated.[141]

Second, where an item of property (such as cash) was deposited with the bank and 'appropriated for a given purpose'.[142] This occurred in *W.P Greenhalgh & Sons v Union Bank of Manchester*.[143] The claimants had sold cotton to W & Sons who onsold the cotton to spinners. The purchase consideration was settled by the spinners who issued a bill of exchange in favour of W & Sons. The bill was remitted by W & Sons to the defendant bank which credited the proceeds of the bill to the W & Sons' account thereby reducing the overdraft. The plaintiffs contended that the bill of exchange was remitted to the bank for a specific purpose (namely securing the purchase price which was owed by W & Sons to the claimants) and that the bank had actual knowledge of this purpose. It was held that:

---

[137] Hapgood op cit 602, Ellinger et al op cit 250, *National Westminster Bank Ltd* (supra) at 646d-f and 653h-j.
[138] Ellinger et al 253.
[139] Ibid 257.
[140] Ibid. In this scenario the foreign bank is an office of the local bank. Where the foreign bank is incorporated as a separate legal entity in the foreign jurisdiction, then the banker's right of set-off does not apply.
[141] Ibid.
[142] Ibid 253.
[143] [1924] 2 KB 153 cited and discussed in Ellinger et al op cit 257.

University of Cape Town

> 'If a person making a payment of money...to another, states definitely that such payment is to be used for a particular purpose, and the person to whom it is made does not dissent, he accepts it for the purpose and must use it...only for the purpose for which he receives it...'[144]

Although this case dealt with the rights of third parties, it is also authority for the principle that where a single customer holds more than one account with a bank and monies are deposited with the bank which are to be appropriated for a specific purpose and the bank has actual knowledge of this specific purpose, then the bank may not combine accounts to the extent of the amount of funds earmarked for the specific purpose.[145] This principle was subsequently confirmed in by the House of Lords in *Barclays Bank Ltd v Quistclose Investments Ltd*.[146]

Third, a bank cannot combine a customer's private account with a trust account held by it or with an account held by it in its capacity as trustee. The bank however must have actual knowledge that the monies in the account are being held in trust or for a trust.[147]

5.2. Statutory set-off on insolvency

The provisions governing the right of set-off on insolvency are to be found in different pieces of legislation. Set-off on bankruptcy is dealt with in s 323 of the Insolvency Act[148] and set-off on administration and liquidation is dealt with in Rules 2.85 and 4.90 of the Insolvency Rules[149] respectively. Despite this, the wording of the provisions governing set-off on administration and liquidation is virtually identical and the main principles applicable in liquidation apply equally to set-off on administration and bankruptcy.[150]

Accordingly, only Rule 4.90 governing set-off on liquidation will be analysed. For comparative purposes s 323 of the Insolvency Act[151] is contained in Appendix IV hereto.

Rule 4.90 reads as follows:

> '4.90.—Mutual credits and set-off
>
> (1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.

University of Cape Town

[144] Ibid 161.
[145] Ellinger et al op cit 258.
[146] [1970] AC 567 (HL). Cited and discussed in Ellinger et al op cit 258.
[147] Ellinger et al op cit 259-260.
[148] 1986 c. 45.
[149] SI 1986/1925
[150] Andrew R Keay & Peter Walton *Insolvency Law Corporate and Personal* 2 ed (2008) 524.
[151] 1986 c 45.

(2) The reference in paragraph (1) to mutual credits, mutual debts or other mutual dealings does not include–

(a) any debt arising out of an obligation incurred at a time when the creditor had notice that–

(i) a meeting of creditors had been summoned under section 98; or

(ii) a petition for the winding up of the company was pending;

(b) any debt arising out of an obligation where–

(i) the liquidation was immediately preceded by an administration; and

(ii) at the time the obligation was incurred the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator;

(c) any debt arising out of an obligation incurred during an administration which immediately preceded the liquidation; or

(d) any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into–

(i) after the company went into liquidation;

(ii) at a time when the creditor had notice that a meeting of creditors had been summoned under section 98;

(iii) at a time when the creditor had notice that a winding up petition was pending;

(iv) where the liquidation was immediately preceded by an administration, at a time when the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator; or

(v) during an administration which immediately preceded the liquidation.

(3) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.

(4) A sum shall be regarded as being due to or from the company for the purposes of paragraph (3) whether–

(a) it is payable at present or in the future;

(b) the obligation by virtue of which it is payable is certain or contingent; or

(c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion.

University of Cape Town

(5) Rule 4.86 shall also apply for the purposes of this Rule to any obligation to or from the company which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value.

(6) Rules 4.91 to 4.93 shall apply for the purposes of this Rule in relation to any sums due to the company which–

(a) are payable in a currency other than sterling;

(b) are of a periodical nature; or

(c) bear interest.

(7) Rule 11.13 shall apply for the purposes of this Rule to any sum due to or from the company which is payable in the future.

(8) Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively the balance (if any) owed to the company shall be paid to the liquidator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable.

(9) In this Rule 'obligation' means an obligation however arising, whether by virtue of an agreement, rule of law or otherwise.'

University of Cape Town

The application of Rule 4.90 on insolvency is mandatory and creditors may not contract out of its provisions.[152] Although *Halesowen HL* (supra) dealt with s 31 of the Bankruptcy Act, 1914 the section is almost identical to Rule 4.90(3).[153] It was made applicable to companies by s 317 of the Companies Act, 1948.[154] More recently, it was held in *Stein v Blake*[155] that the set-off is 'automatic and self-executing' and that it operates without any steps having to be taken by either of the parties.[156]

While Rule 4.90 is largely self-explanatory, certain aspects of the Rule require further analysis. Rule 4.90(1) applies where 'there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company'. The operative provision states that an 'account shall be taken of what is due from each party to the other in respect of the

---

[152] *Halesowen, HL* (supra) at 649c, 652b-e, 663j-p and 662e-f.
[153] The wording of s 31 of the Bankruptcy Act, 1914 is reproduced in *Halesowen HL* (supra) at 646g.
[154] *Halesowen HL* at 646h-j.
[155] [1996] 1 AC 243, HL at 257F-258D cited in Hapgood op cit 614. Available at http://www.bailii.org/uk/cases/UKHL/1995/11.html accessed on 20 December 2012.
[156] *Stein* supra at 253C-254H cited in Hapgood loc cit.

mutual dealings…' between the insolvent company and its creditor or debtor and 'the sums due from one party shall be set off against the sums due from the other.'[157] Mutual dealings must be between the same persons 'in the same right'.[158]

The requirement that the debt must be owed by the solvent to the insolvent may seem obvious and is unproblematic where the customer (as borrower) has gone into insolvency. Even if the bank does not have a guarantee from the third party depositor, it can exercise its rights under the charge. The situation may however become complex when a third party has provided security in the form of a cash deposit with the bank and the bank (as lender) has gone into liquidation. This is a rare occurrence but it can and does happen.[159]

The third party is often the holding company of the customer (borrower) and the cash collateral is used as security for obligations of the customer. In addition to the cash collateral, the third party may also guarantee performance of the customer or assume the liabilities of a principal debtor. There are two possible approaches in this scenario.[160] In the first approach, which will be referred to as the liquidator's approach, the liquidator of the lender will wish to prove a claim against the borrower for the full amount of the loan and retain the deposit of the third party, which will have a concurrent claim against the insolvent lender. In the second approach, which will be referred to as the depositor's approach, the third party (as depositor) will want the liquidator of the lender to set-off the deposit against the loan owed by the borrower to the insolvent lender.

The difference between the two approaches is not merely of theoretical interest and can yield significantly different results in practice. For illustrative purposes, consider the example where the loan and the deposit are both in the amount of R1 million and the concurrent claim of third party depositor will yield a dividend of 10 cents in the Rand (i.e. R100,000). On the liquidator's approach the liquidator will retain the R1 million deposit and claim the full R1 million from the borrower. The aggregate cost to the borrower and the third party will be R1.9 million (ie. the R1 million owed by the borrower to the insolvent lender and the R900,000 which the third party depositor is unable to recover from the insolvent lender). On the depositor's

---

[157] Rule 4.90(3) (emphasis added)
[158] Hapgood op cit 613 note 1.*Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568, HL ('*BCCI*').
[159] Hapgood op cit 617.
[160] For brevity in the discussion that follows, the bank will be referred to as the lender and the customer as the borrower.

University of Cape Town

approach however, the loan and the deposit will be set-off against one another. In the result, the aggregate cost to the borrower and third party depositor will be nil.[161]

It was precisely this clash of approaches which occurred in the case of *MS Fashions.*[162] In the security documentation, the depositor had assumed the liabilities of a principal debtor. The Court of Appeal held that the amount of the loan owing by the borrower had to be set off in terms of Rule 4.90 against the amount of the deposit. There was no need for the liquidator to make demand because the liabilities of the principal debtor were enforceable without the need for such a demand.[163]

The facts of the BCCI case were almost identical to those in *MS Fashions* (supra). The security documentation however did not create a liability of principal debtor for the depositor. In summarising the 'Letter of Lien/Charge' Lord Hoffmann stated that 'the document does not contain any promise by Mr Jessa to pay what may be due from Rayners to the bank'.[164] The depositor (Mr Jessa) did not promise as guarantor nor assume liability of principal debtor the obligations of the borrower (Rayner Enterprises Inc). It was on this point that the House of Lords distinguished *Ms Fashions* (supra) from *BCCI* (supra):

'The case [*MS Fashions* (supra)] involved a very unusual security document in which, although no personal obligation was expressly created, references were made to the liability of the depositor being that of the principal debtor. It was only to give effect to these words that the document was construed as creating a personal liability limited to the amount of the deposit. This was held to result in a set-off between depositor and BCCI which, since depositor and principal debtor were jointly and severally and unconditionally liable for the same debt, discharged the principal debtor.'[165]

The House of Lords noted that it was anomalous that a depositor who gave a personal guarantee could be worse off than a depositor who assumed joint and several liability with the borrower. In the case of a personal guarantee, a demand for payment from the guarantor prior to the grant of the order of liquidation was required in order for the debt to be 'due' by the

---

[161] Hapgood loc cit.
[162] *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq.) (No 2), High Street Services Ltd v Bank of Credit and Commerce International SA (in liq.), Impexbond Ltd v Bank of Credit and Commerce International SA (in liq.)* [1993] 3 All ER 769, CA.
[163] Ibid at 778h-j.
[164] *BCCI* (supra) per Lord Hoffmann at 572f
[165] Ibid at 574h-j.

University of Cape Town

guarantor and for there to be mutuality of dealings between the bank and the guarantor at the time when the order of liquidation was granted. The distinction was artificial because the bank would not wish to rely on the depositor's personal liability; the bank 'will simply keep the money in accordance with the letter of charge.'[166] The difficulty with resolving this anomaly was arriving at a different answer which recognises 'the automatic and self-executing nature of set-off under Rule 4.90 and the principle that joint and several debtors are liable for the same debt so that payment or deemed payment by the one discharges the other'.[167] In the case of a charged (i.e. encumbered) deposit it may be that the existence of the charge destroys mutuality: the bank's claim against the depositor is in its own right but the depositor's claim against the bank is subject to the bank's equitable interest. This possibility was rejected in *MS Fashions* (supra).[168]

In the Court of Appeal in *BCCI* (supra), another possibility was suggested: the collection and distribution of assets takes place retrospectively; it follows that the debt would be immediately recovered from the depositor (as principal debtor) prior to Rule 4.90 being applied on insolvency and once the debt was discharged there would be nothing left to set-off.[169] Lord Hoffmann expressly refrained from commenting on the debate and left it open for decision in the unlikely event that documentation such as that in *MS Fashions* (supra) appeared in another liquidation.[170]

The requirement of mutuality of credits, debts and other dealings was also considered in *Halesowen HL* (supra). It was held that the Court of Appeal had taken an unduly narrow view of mutuality and that both the no. 1 account and the no. 2 account formed part of the relationship between banker and customer.[171] Viscount Dilhorne cited with approval the following statement of Buckley LJ in his dissenting judgement in the Court of Appeal:[172]

> 'Each of the obligations on either side on the two banking accounts arose from the relationship between the parties as banker and customer….The agreement was intended to have temporary effect only, at the end of which the parties contemplated that both accounts would become part of their general banking relationship as banker and customer.'[173]

University of Cape Town

[166] Ibid at 575c.
[167] Ibid 575c-d.
[168] *MS Fashions* (supra) at 786a-b (court a quo), 788f/g (Court of Appeal).
[169] Cited in *BCCI* (supra) at 575d-e.
[170] Ibid at 575f-g.
[171] *Halesowen HL* (supra) at 650b-h, 651g-652a, 654j – 655c, 662h, 663e.
[172] Ibid at 650d-g.
[173] *Halesowen CA* (supra) at 490e-g per Buckley LJ.

The House of Lords observed that every contractual provision has special or specific purpose in the ordinary sense of those words but that something additional was required to exclude a transaction from the concept of 'mutual dealings'. Monies paid or deposited for a special or specific purpose would be excluded from that concept if it would be a 'misappropriation' to use it for any other purpose.[174]

Rule 4.90(1) applies to mutual credits, mutual debits and mutual dealings which arose or took place 'before the company *goes into liquidation*'. Section 247(2) of the Insolvency Act 1986 provides that a company goes into liquidation when it passes a resolution for its winding up or when the order of winding up is made by the court. This must be distinguished from the *commencement of liquidation* which is either the time of the passing of a resolution in a voluntary winding up or when the petition for winding up is before the court (or the time of passing any pre-petition resolution for the winding up of the company). This creates the possibility of a conflict between Rule 4.90 and the provisions of s 127(1) of the Insolvency Act 1986 which renders any disposition of a company's property void if it is made after the commencement of winding up (unless the court orders otherwise). On the one hand, to the extent that s 127 might conflict with Rule 4.90, the provisions of the section may well prevail.[175] This is most disturbing because in the case of a court ordered winding up the liquidation will always commence prior to the company going into liquidation. Its effect will be to render Rule 4.90 inapplicable with a resulting inconsistency between set-off on liquidation and set-off on bankruptcy.[176] It is submitted that this could never have been the intention of the drafters of either the Act or the Rules and offends against set-off on insolvency being an exception from the pari passu principle.[177] It can be argued that the *making* of a disposal implies an act or omission by either the insolvent or its creditor. Where a disposal occurs or takes place due to self-executing, subordinate legislation, it has not been made by either of the parties but has rather taken place automatically by operation of law (as the Rules are subordinate legislation).

As appears from Rule 14(4), the mutual credits and debts which are set-off can be payable at present or in the future, certain or contingent in nature, or its amount is fixed, liquidated, capable of being ascertained by fixed rules or as a matter of opinion.

---

[174] *Halesown HL* (supra) at 651h-652a.
[175] Hapgood op cit 614.
[176] Which is provided for in s 323 of the Insolvency Act 1986 and not in the Rules.
[177] Keay & Walton op cit 456.

University of Cape Town

The reference to 'matter of opinion' is consistent with Rule 14.90(5) which applies Rule 4.86 to any obligation uncertain in value due to a contingency or for any other reason. Rule 4.86 also permits the liquidator to revise an estimate should circumstances change or information become available to them.

A contingent liability can be quantified right up to the time until account is taken of it and it will be backdated to the date of liquidation. As Lord Hoffmann in *Stein* (supra) stated:[178]

> 'The first is to take into account everything which has actually happened between the bankruptcy date and the moment when it becomes necessary to ascertain what, on that date, was the state of account between the creditor and the bankrupt. If by that time the contingency has occurred and the claim has been quantified, then that is the amount which is treated as having been due at the bankruptcy date.'

The court drew an important distinction between the date of bankruptcy (or liquidation) and the date when the liability is quantified which may well be some time after the date of bankruptcy (or liquidation)[179]. Even if the contingency does not become an actual direct liability, a change in circumstances may still require that the original estimate be revised. The second method which the court then proceeds to described is that contained in s 322(3) of the Insolvency Act 1986 which is very similar to Rule 4.86. This requires that the trustee estimate the contingent liability or any liability which does not bear a certain value and this estimate is then backdated to the date of bankruptcy. In *MS Fashions* (supra) Lord Hoffmann referred to this as the 'hindsight principle'.[180]

Rule 4.86 only applies where the insolvent person or entity has a claim against a solvent debtor. The court in *Stein* (supra) commented that there is no such technique for quantifying contingent or unascertained claims against the creditor of the insolvent because 'it would be unfair upon him to his liability to pay advanced merely because the trustee wants to wind up the bankrupt's estate'.

Rule 40.90 (6) applies the provisions of Rule 4.91 (where a debt is incurred or payable in a foreign currency), Rule 4.92 (where a creditor has a claim for debts of a periodical nature) and Rule 4.93 (interest which may be levied after the company went into liquidation). Rule 11.13

---

[178] Para [6].
[179] As noted above, the date of bankruptcy or liquidation is when the court makes the relevant order. This must not be confused with the commencement of the liquidation.
[180] At 777g.

University of Cape Town

provides for debts payable in future which are quantified by discounting by five percent per annum.

5.3. Set-off and assignment

The effect of assignment by a customer of its rights to a deposit held with a bank was summarised in *Business Computers Ltd v Anglo-African Leasing Ltd* which summarised the position as follows:

> 'The result of the relevant authorities is that a debt which accrues due before notice of an assignment is received, whether or not it is payable before that date, or a debt which arises out of the same contract as that which gives rise to the assigned debt, or is closely connected with that contract, may be set off against the assignee. But a debt which is neither accrued nor connected may not be set off even though it arises from a contract made before the assignment.'[181]

Of significance to banks is the requirement that the debt must be due (even if it is payable in future) thereby excluding contingent debts from its scope of operation. For example, suppose a bank has issued a letter of credit on the instructions of its customer and has taken its customer's deposit as security. The customer assigns its rights to repayment of the deposit to a third party and the bank only pays out under the letter of credit after it has received notice of the assignment. Thus, the bank's claim against the customer only undergoes the transformation from contingent to due after it has received the notice of assignment thereby depriving the bank of the right to set-off the the amount paid out under the letter of credit against the assignee's rights to the deposit.[182] As in the case of South African law, it would be prudent for the bank to ensure the presence of adequate restrictions on assignment by the customer of any claims it may have against the bank.

Regarding the degree of closeness required of the connectedness between the two debts and the contract, the facts of *Business Computers* (supra) provide some guidance. In casu, the plaintiff sold two computers pursuant to two higher purchase agreements ('the first two HP agreements') to the defendant which in turn on sold them on higher purchase to other parties. The total amount owed by the defendant for these transactions was in the sum of £10,587.50. Plaintiff also sold a computer to the defendant for its own use and leased back the computer from the defendant ('the third HP agreement'). The plaintiff was thus the lessee under that agreement

University of Cape Town

---

[181] [1977] 2 All ER 741 at 748b cited in Hapgood op cit 619.
[182] Ibid 620.

and was obliged to pay rental to the defendant. Financing for the plaintiff's operating expenses had been obtained by the plaintiff in the form of bank loans and it had issued debentures as security for these loans.

The plaintiff became insolvent and defaulted on its obligations under the third HP agreement with the defendant by failing to pay rent in the amount of £1,477.20. In terms of the third HP agreement should the plaintiff fail to pay any instalment in respect of rent for a period exceeding more than fourteen days after it had fallen due and payable, the defendant could determine (ie terminate the contract) and recover all arrears as well as damages calculated in accordance with the contract. On 13 June the debenture holders appointed a receiver. The effect of this was to transform the incomplete assignment of the first two HP agreements to the debenture holders to a complete assignment:[183]

> 'A floating charge is ambulatory and hovers over the property until some event occurs which causes it to settle and crystallise into a specific charge...One of the events which causes crystallisation is the appointment of a receiver...One of the consequences of the receiver's appointment by the debenture holders was that the incomplete assignment constituted by the [debenture] became converted into a completed equitable assignment to them of the assets charged... '[184]

The receiver gave the defendant notice of the assignment on 17 June. It was therefore common cause that the amount of £10,587.50 could be set-off against the amount owing by the plaintiff to the defendant in the amount of £1,477.20 leaving a balance owing of £9,110.30. It should be emphasized that as at this date, the defendant had still not determined the third HP agreement and the amount of £1,477.20 was therefore the only amount due to the defendant under this agreement. On 31 July the receiver repudiated the third HP agreement and this repudiation was accepted on 8 August by the defendant. It was only at this date that the defendant obtained the right to claim £30,000 in damages from the plaintiff in accordance with the third HP agreement.[185]

The defendant sought to set-off this amount of £30,000 against the amount of £9,110.30 it owed the plaintiff, which (by the receiver) objected on the grounds that amounts owing were in

---

[183] *Business Computers* (supra) at 745c.
[184] Per Edmund Davies LJ in *George Barker (Transport) Ltd v Eynon* [1974] 1 All ER 900 at 905b cited with approval in *Business Computers* (supra) at 745d.
[185] *Business Computers* (supra) at 746b-c.

University of Cape Town

respect of different contracts and any set-off would be subject to the debenture holders complete assignment (thereby rendering them complete assignees) which took place on 17 June.

The court held that the first two HP agreements and the third HP agreement were insufficiently closely related to one another and that the defendant could not set two amounts off. It further held that since the assignment became complete on 17 June, the amount of £30,000 could not be set-off against the assignees because it only became due on a later date when the third HP agreement was determined (on 8 August).[186]

University of Cape Town

[186] Ibid.

6. CASH MANAGEMENT IN SOUTH AFRICA: MULTIPLE LEGAL ENTITIES

6.1. Introduction and regulation 13

Cash management for multiple legal entities is governed by regulation 16 read together with the definition of 'cash management scheme' contained in regulation 65 of the Regulations.[187] The definition contemplates an actual scheme whereby cash balances are transferred between participating companies within the same group (whose financial statements are required to be consolidated). Whereas cash management for single legal entities may be availed of by any type of legal entity, this is not the case with multiple legal entities.

Before dealing with regulation 16, it must be asked whether regulation 13 may be used by companies as an alternative to regulation 16 and whether entities other than companies can rely on regulation 13 for legal set-off (in relation to multiple legal entities). In terms of s 6(b) of the Interpretation Act[188] in every law, which includes subordinate legislation, unless the contrary intention appears words in the singular number include the plural, and words in the plural number include the singular. It follows that the only impediment to using regulation 13 for multiple companies or for multiple entities other than companies is if a contrary intention appears from the Regulations.

Regulation 16 read together with the definition of 'cash management schemes' specifically deals with cash management of companies within a group. The implication (albeit not a necessary implication) of this specific provision is that it was intended to exclude the more general regulation 13, at least where a group of companies are concerned. On the other hand, the definition of 'cash management scheme' is very specific and includes interest optimisation by way of transferring balances. It remains silent on interest optimisation by way of other methods such as notional set-off in terms of regulation 13. It is submitted that in this regard the position is unclear.

What then is the position of entities other than companies? May they rely on regulation 13? It can be argued that had it been intended to exclude multiple legal entities from relying on regulation 13, the drafter would not have introduced the concept of an 'obligor' in paragraphs 2(b) and (3) and simply used the term 'person' in its place. Paragraph (3) would then have defined a 'person' as excluding the definition of 'person' in regulation 65.

---

[187] See paragraph 1.1 above for the definition of a cash-management scheme.
[188] Act 33 of 1957.

University of Cape Town

Regulation 65 defines a 'person' as including:

'(a) two or more persons, whether natural or juristic, that, unless proved to the contrary, constitute a single risk due to the fact that one of them has direct or indirect control over the other or others; or

(b) two or more persons, whether natural or juristic, between whom there is no relationship or control as referred to in (a) above, but that are to be regarded as constituting a single risk, due to the fact that they are so interconnected that should one of them experience financial difficulties, the other or all of them would be likely to encounter repayment difficulties;'.

Thus, it appears that the exclusion, in regulation 13(3), of the definition of a 'person' in regulation 65 takes the matter no further.

However, the very introduction of the term 'obligor' in paragraph (3) implies that the customer and the 'obligor' are not necessarily one and the same person. It therefore remains a possibility persons other than companies such as natural persons, close corporations and trusts could rely on regulation 13 for multiple legal entity set-off. However, due to the current difficulty with the enforceability of set-off on insolvency in South African law, it is not possible to comply with regulation 13 whether for a single legal entity or multiple legal entities.

6.2. <u>Regulation 16</u>

This regulation applies to cash management schemes as defined in regulation 65 and reads as follows:

'16. Cash-management schemes

(1) Unless specifically otherwise specified or prescribed in these Regulations, the reduction of balances resulting from the application of a cash-management scheme shall be taken into account in completing the prescribed forms only when all of the conditions specified below are met.

(a) The cash-management scheme shall be conducted only for companies that are subsidiaries of the same holding company and that are included in the group audited annual financial statements of such holding company, as well as for such holding company.

(b) Any transfers of debit or credit balances from individual accounts to a central group account shall be shown as actual transactions on individual accounts, as well as in the accounting records of the individual account holders, in order to ensure that the

University of Cape Town

accounting system of the relevant bank reflects the true debtor/creditor and legal relationships.

(c) The bank shall provide its clients with statements of account evidencing the effect of transfers, whenever such transfers are made between their accounts and a central group account, in order to enable the clients of the bank to make the necessary entries to ensure that their respective accounting records reflect the true debtor/creditor and legal relationships *vis-a-vis* the bank (except for uncleared items, balances in the books of clients should therefore correspond to balances on client accounts in the accounting system of the relevant bank).

(d) A group account, or any other account to which transfers are made, shall be in the name of a legal entity in order to protect the legal position of the bank.

(e) Any transfer between client accounts and a central group account shall be supported by legal authorisation granted to the bank by its clients, including resolutions of clients' boards of directors to effect such transfer.

(f) Written agreements whereby authorisation is granted as contemplated in paragraph (e) shall legally limit the bank's risk to the debtor/creditor relationship that exists after transfers have been effected.

(g) Any statutory return shall reflect the true debtor/creditor and legal relationships of the bank *vis-a-vis* its clients.

(h) The bank entering into written agreements relating to cash-management schemes with its clients shall ensure that the clients are fully aware that after the transfer of balances on their accounts, they have no claim against or obligation to the bank in respect of the amounts so transferred.

(i) The bank shall ensure that all written agreements relating to cash-management schemes entered into by it with clients are legal and binding.

(j) Any cash-management scheme involving the transfer of balances among different legal entities, as well as a standardised written agreement, providing for the conduct of such a scheme, entered into between a bank and its clients, shall be submitted to the Registrar for approval.'

It is readily apparent from paragraphs (a) to (d) that funds are actually (not just notionally) transferred from one legal entity to or from a central group account. In order to optimise interest paid or earned, the participating companies in the group will transfer all credit balances to this group account and finance any debit balances from the group account at close of business each day. In this manner, the group will earn or pay interest on the basis of the single balance of the

University of Cape Town

nominated group account resulting in the efficiencies mentioned in Chapter 1. Accounting records are to be kept by the bank evidencing these transfers and the resultant balances on the various accounts of participating companies.

Of particular interest is paragraph (j) which requires a standardised agreement to be forwarded to the Registrar of Banks for their approval. Paragraphs (e) to (j) when read together conveys the Regulations concern that the agreements entered into and the conduct of the scheme are legally effective, valid and binding. This is understandable given the large amounts of funds that are transferred daily into or from the central bank account. Any scheme which is lacking in its legal effectiveness and validity may well expose the bank to sizeable liability.

This is in stark contrast to regulation 13 which merely sets out the basic requirements for single entity set-off without the rigorous legal requirements and oversight functions of the Registrar of Banks. It is unclear how or why there is this inconsistency between the two regulations especially since the company with whom the central group account is held will wish to avail of regulation 13 as a single entity to ensure interest optimisation.

University of Cape Town

7. CASH MANAGEMENT IN ENGLAND: MULTIPLE LEGAL ENTITIES

The Financial Services Authority's Handbook provides that the Interpretation Act 1978[189] applies to the Handbook[190] and that this has the effect that unless the contrary appears words in the Handbook in the singular include the plural and words in the plural include the singular.[191]

It is therefore permissible to interpret BIPRU 5.3 as applying to loans and deposits between the bank and *counterparties*. This can legally be achieved by the bank obtaining cross-suretyships from the multiple legal entities participating in the cash management scheme. As has been demonstrated earlier, not only is set-off on insolvency possible in England but it is mandatory and applies to contingent liabilities as well. Because multiple counterparties are involved the bank should, in addition to cross-suretyships, obtain the right to set-off *at any time* any balances owed by any of the counterparties to the bank against any of the balances owed by the bank to any of the counterparties and restrict the counterparty's right of assignment of any deposits with the bank. This will allow the bank to comply with BIPRU 5.3 and capital need only held on the notional net balance of all the participating counterparties.

Nothing precludes a bank from offering a multiple customers a cash management scheme involving actual pooling and transfer of funds (such as is the case with cash management for multiple legal entities in South Africa) but the existence of a simple notional pooling system is likely to be preferred by all parties concerned. It saves the bank and the participating customers the burden of having to keep track of and calculate interest on intercompany loans on a daily basis. It is also open to participating customers to limit their liability under the cross-suretyship to credit balances which they hold with the bank.

University of Cape Town

---

[189] Chapter 30.

[190] GEN 2.2.11 of the FSA Handbook available at http://fsahandbook.info/FSA/html/handbook/GEN/2/2#D38, accessed on 28 December 2012.

[191] Ibid GEN 2.2.12 (3) (b).

8. CONCLUSION

Set-off on insolvency in South African law is problematic. The weight of authority supports set-off as operating automatically and *ipso iure* and not retrospectively after being invoked by one of the parties. Obtaining a contractual right to set-off on insolvency (or just prior to insolvency) does not occur within the ordinary course of business and in terms of s 46 of the Insolvency Act[192] may be impeached and set aside. Consequently, it is submitted that regulation 13 cannot be given effect to and may not be used for single entity cash management purposes. There exists the possibility that if the South African Law Commission's proposed Bill is adopted, a right of set-off enforceable on insolvency may be possible. This will represent a fundamental shift in the South African law of set-off and insolvency. If and when a new Insolvency Act is passed into law is uncertain as is the content of such a piece of legislation. Although it is also uncertain how broadly or narrowly the court's will interpret new legislation dealing with set-off on insolvency, it is submitted that a broad interpretation is correct and will permit regulation 13 to be given effect to.

In contrast, English law mandates set-off on insolvency. A notional set-off scheme is therefore possible in English law and complies with the FSA's Handbooks requirement of an enforceable right of set-off on bankruptcy for on-balance sheet netting. The relevant Handbook provision can also be interpreted in the plural and may therefore be used for cash management of multiple legal entities.

It is submitted that in South Africa the Regulations only provide for notional set-off for single legal entities and cash management schemes, in order to comply with regulation 16, must be actual pooling schemes where actual transfers of funds take place. This generates intercompany loans which attract in administrative burden in that they must be constantly updated and interest calculated on a daily basis. There may also be tax implications for multiple legal entities who in good faith are simply seeking to optimise their interest earnings or expense, and not avoid tax. Accordingly, a notional cash management scheme for multiple legal entities is preferable.

University of Cape Town

[192] Act 24 of 1936.

APPENDIX I

COMPARISON OF NET INTEREST CHARGED WHERE AGGREGATE DEBIT BALANCES EXCEED AGGREGATE CREDIT BALANCES				
Account number	Balance	Interest earned @5%	(Interest charged @10%)	(Net interest charged)
SEPARATE REPORTING OF AGGREGATE DEBIT AND CREDIT BALANCES ('GROSS' BALANCES)				
1	R1000 credit	R50		
2	R4000 debit		(R400)	
3	R2000 debit		(R200)	
TOTAL		R50	(R600)	**(R550)**
REPORTING OF NET BALANCE				
1	R1000 credit			
2	R4000 debit			
3	R2000 debit			
NET BALANCE	R5000 debit		(R500)	**(R500)**

University of Cape Town

APPENDIX II

COMPARISON OF NET INTEREST EARNED WHERE AGGREGATE CREDIT BALANCES EXCEED AGGREGATE DEBIT BALANCES				
Account number	Balance	Interest earned @5%	(Interest charged @10%)	Net interest earned
SEPARATE REPORTING OF AGGREGATE DEBIT AND CREDIT BALANCES ('GROSS' BALANCES)				
1	R1000 debit		(R100)	
2	R4000 credit	R200		
3	R2000 credit	R100		
TOTAL		R300	(R100)	**R200**
REPORTING OF NET BALANCE				
1	R1000 debit			
2	R4000 credit			
3	R2000 credit			
NET BALANCE	R5000 credit	R250		**R250**

University of Cape Town

APPENDIX III

BIPRU 5.3 On balance sheet netting

Eligibility

BIPRU 5.3.1
01/01/2007

A *firm* may recognise as eligible the on-balance sheet netting of mutual claims between the *firm* and its counterparty.
[**Note**: *BCD* Annex VIII Part 1 point 3]

BIPRU 5.3.2
01/01/2007

Without prejudice to *BIPRU 5.6.1 R*, eligibility is limited to reciprocal cash balances between a *firm* and a counterparty. Only loans and deposits of the *lending firm* may be subject to a modification of *risk weighted exposure amounts* and, as relevant, *expected loss* amounts as a result of an on-balance sheet netting agreement.
[**Note**: *BCD* Annex VIII Part 1 point 4]

Minimum requirements

BIPRU 5.3.3
01/01/2007

For on-balance sheet netting agreements - other than master netting agreements covering *repurchase transactions*, *securities or commodities lending or borrowing transactions* and/or other *capital market-driven transactions* - to be recognised for the purposes of *BIPRU 5* the following conditions must be satisfied:

(1) they must be legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;

(2) the *firm* must be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;

(3) the *firm* must monitor and control the risks associated with the termination of the credit protection; and

(4) the *firm* must monitor and control the relevant *exposures* on a net basis.
[**Note**: *BCD* Annex VIII Part 2 point 3]

University of Cape Town

Calculating the effects of credit risk mitigation

BIPRU 5.3.4
01/01/2007

Loans and deposits with a *lending firm* subject to on-balance sheet netting are to be treated as cash collateral.
[**Note**: *BCD* Annex VIII Part 3 point 4]

University of Cape Town

APPENDIX IV

323.- Mutual credit and set-off.

(1) This section applies where before the commencement of the bankruptcy there have been mutual credits, mutual debts or other mutual dealings between the bankrupt and any creditor of the bankrupt proving or claiming to prove for a bankruptcy debt.

(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other.

(3) Sums due from the bankrupt to another party shall not be included in the account taken under subsection (2) if that other party had notice at the time they became due that a bankruptcy petition relating to the bankrupt was pending.

(4) Only the balance (if any) of the account taken under subsection (2) is provable as a bankruptcy debt or, as the case may be, to be paid to the trustee as part of the bankrupt's estate.

University of Cape Town

BIBLIOGRAPHY

PRIMARY SOURCES

South African cases

Administrator, Natal v. Magill, Grant and Nell (Pty) Ltd (In Liquidation) 1969 (1) SA 660 (A).

Affirmative Portfolios cc v Transnet Ltd t/a Metrorail 2009 (1) SA 196(SCA).

Agricultural and Industrial Mechanisation (Vereeniging) (Pty) Ltd v Lombard 1974 (3) SA 485 (O).

Bain v Barclays Bank 1937 SR 191.

Clark v Van Rensburg 1964 (4) 153 (O).

Dantex Investment Holdings (Pty) Ltd v National Explosives (Pty) Ltd (in liquidation) 1990 (1) SA 736 (A).

Estate Wege v Strauss 1932 AD 76.

Hardy NO & Mostert v Harsant 1913 TPD 433.

Hendriks v Swanepoel 1962 (4) SA 338 (A).

Herrigel NO v Bon Roads Construction Co (Pty) Ltd and another 1980 (4) SA 669 (SWA).

Joint Municipal Pension Fund (Transvaal) v Pretoria Municipal Pension Fund 1969 (2) SA 78 (T).

Malherbe's Trustee v Dinner 1922 OPD 18.

National Bank v Cohen's Trustee 1911 AD 235.

Nichol v Burger 1990 (1) SA 231 (C).

Oudtshoorn Town Council v Smith 1911 CPD 558.

Roman Catholic Church (Klerksdorp Diocese) v Southern Life Association Ltd 1992 (2) SA 807 (A).

Southern Cape Liquors (Pty) Ltd v Delipcus Beleggings BK 1998 (4) SA 494 (C).

The Government v Thorne and another, NNO 1974 (2) SA 1 (A).

The Standard Bank of South Africa Ltd v Echo Petroleum cc 2012 (5) SA 283 (SCA).

Thorne and another, NNO v The Government 1973 (4) SA 42 (T).

Walker v Syfret NO 1911 AD 141.

Willis Faber Enthoven (Pty) Ltd v Receiver of Revenue 1992 (4) SA 202 (A).

English cases

Barclays Bank Ltd v Quistclose Investments Ltd [1970] AC 567 (HL).

University of Cape Town

Business Computers Ltd v Anglo-African Leasing Ltd [1977] 2 All ER 741.

George Barker (Transport) Ltd v Eynon [1974] 1 All ER 900, CA.

Halesowen Pressworks & Assemblies Ltd v Westminster Bank Ltd [1970] 1 All ER 33.

Halesowen Presswork & Assemblies Ltd v Westminster Bank Ltd [1970] 3 All ER 473,CA.

MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq.) (No 2), High Street Services Ltd v Bank of Credit and Commerce International SA (in liq.), Impexbond Ltd v Bank of Credit and Commerce International SA (in liq.) [1993] 3 All ER 769, CA.

National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd [1972] 1 All ER 641, HL.

Re Bank of Credit and Commerce International SA (No 8) [1997] 4 All ER 568, HL.

Stein v Blake [1996] 1 AC 243, HL, available at http://www.bailii.org/uk/cases/UKHL/1995/11.html accessed on 20 December 2012.

W.P Greenhalgh & Sons v Union Bank of Manchester [1924] 2 KB 153.

Web sources

FSA Handbook available at http://fsahandbook.info/FSA/index.jsp accessed on 11 December 2012.

Legislation

Banks Act 94 of 1990.

Companies Act 61 of 1973.

Companies Act 71 of 2008.

Financial Services and Markets Act 2008 c. 8.

Insolvency Act 24 of 1936.

National Payment System Act 78 of 1998.

Securities Services Act 36 of 2004.

Regulations

Regulations relating to banks promulgated in terms of s 90 of the Banks Act 94 of 1990 published in GNR 3 *GG 30629* of 1 January 2008.

SALC Projects

South African Law Commission Discussion Paper 86 (Project 63) *Review of the Law of Insolvency* vol 1 (2000).

University of Cape Town

SECONDARY SOURCES

Articles

Van Niekerk, B V D 'Some thoughts on the problem of set-off' (1968) 85 *SALJ* 31

'The Banker's Guide to the Basel II Framework' published by the Banking Association of South Africa (compiled by P Styger and PG Vosloo) (2005) accessed at http://www.banking.org.za/getdoc/getdoc.aspx?docid=848 on 30 March 2012

Textbooks

Bertelsman, Eberhard; Herbert, Walter; Evans, Roger G; Harris, Adams; Kelly-Louw, Michelle; Loubser, Anneli; Roestoff, Melanie; Smith, Alastair; Stander, Leonie; Steyn, Lee & Nagel, CJ (editor) *Mars The Law of Insolvency in South Africa* 9 ed (2008) Juta, Cape Town.

Blackman, M S 'Companies' in WA Joubert (founding ed) *The Law of South Africa* vol 4(3) First Reissue (2006) Butterworths, Durban.

Christie, RH & Bradfield, GB *The Law of Contract in South Africa* 6 ed (2011) LexisNexis.

De Wet, J C & Van Wyk, A H *Die Suid-Afrikaanse Kontraktereg and Handelsreg* 5 ed (1992) Butterworths, Durban.

Ellinger, E P; Lomnicka, Eva & Hare, C V M *Ellinger's Modern Banking Law* 5 ed (2011) Oxford University Press.

Fountoulakis, Christiana *Set-off Defences in International Commercial Arbitration. A Comparative Analysis* (2011) Hart, Oxford.

Hapgood, Mark *Piaget's Law of Banking* 12 ed (2002) LexisNexis, Butterworths.

Harms, L T C 'Obligations' in WA Joubert (founding ed) *The Law of South Africa* vol 19 2 ed (2006) Butterworths, Durban.

Joubert, D J *General Principles of the Law of Contract* (1987) Juta, Cape Town.

Keay, Andrew R & Walton, Peter *Insolvency Law Corporate and Personal* 2 ed (2008) Jordans, Bristol.

Smith, Catherine *The Law of Insolvency* (1982) Butterworths, Durban.

Van der Merwe, S; Van Huysteen L F; Reinecke, M F B & Lubbe, G F *Contract General Principles* 3 ed (2007) Juta & Co, Kenwyn South Africa

The Selective Voet being the Commentary on the Pandects by Johannes Voet (translated by Percival Gane) vol 3 (1956) Butterworths, Durban.

Wessels, J W *The Law of Contract in South Africa* vol II 2 ed (1951) Butterworths, Durban.

University of Cape Town