BANK LITIGATION LIABILITIES

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Scope of the talk

1. This talk will focus on the following sources of litigation liabilities for financial institutions:

   a. some key areas in which banks may incur liabilities to customers and third parties in connection with account operation;

   b. some key practical issues for lenders in debt recovery and security enforcement; and

   c. some key areas where banks and other financial institutions may incur statutory liabilities.

Account operation - the paying bank

2. Claims against a bank which has wrongly paid away funds can generally be grouped under the following main heads:

   a. Breach of mandate;

   b. Negligence; and

   c. Accessory liability.

Breach of mandate

3. Claims for breach of mandate usually arise either because the bank has wrongly refused to make a payment or has wrongly made a payment without proper authority.

4. Claims for breach of mandate are claims for breach of contract and/or for an account. The liability is strict, so issues of contributory negligence do not arise.

5. If a bank wrongly refuses to make a payment for its customer, the customer's claim will be for damages to compensate for any reasonably foreseeable losses incurred by the customer as a result of the bank's failure to pay.

6. A bank which wrongly pays money away when it has no authority to do so will usually be treated as if it had paid using its own funds, not those of its customer. The customer's claim will be for a declaration that the debits made to its account should be reversed out, and for damages to compensate the customer for any reasonably foreseeable losses incurred by the customer as a result of the bank's failure to state the balance of the account accurately.

7. Defences available to the bank include the following:

   a. The payment was in fact authorised or has since been ratified or adopted by the customer even if not originally made in accordance with the mandate.[1]

   b. The customer is estopped from claiming that the payments were made without authority because the customer failed to notify the bank after the customer became aware that payment instructions were being forged or given without authority. To

[1] London Intercontinental Trust Ltd v Barclays Bank Ltd [1980] 1 Lloyds Rep 241.

make out this defence the customer must have had actual knowledge (including so-called "blind eye" knowledge).[2]

c. The customer in fact benefited from the payment by the discharge of a liability to the payee.[3] But to invoke this defence the bank will usually need to show that it had authority to discharge the liability in question.[4]

d. A refusal to make a payment was justified under money laundering or related legislation. To succeed in this defence the bank will need to be able to discharge the burden of showing that it had a reasonable suspicion.[5]

Negligence

8. Even if the payment was made in accordance with the terms of the mandate, the bank will be liable to its customer for damages in negligence if it made the payment in circumstances where it had reasonable grounds (although not necessarily proof) for believing that the instruction to make the payment was an attempt to misappropriate the funds of the customer.[6]

9. Such claims are more likely to succeed where the person authorising the payment is an agent (such as a director of a company) signing payment instructions on behalf of the customer. It is more difficult to see how such a claim could be made where the signatory is an individual customer.[7]

Accessory liability

10. If the funds paid away were, in the hands of the bank's customer, impressed with a trust in favour of a third party, by paying away the funds the bank may incur liability as an accessory for assisting a breach of trust if the bank is found to have acted dishonestly.

11. Though dishonesty can be difficult to prove, it now seems the standard is an objective one.

> "The application of the standard requires one to put oneself in the shoes of the defendant to the extent that his conduct is to be assessed in the light of what he knew at the relevant time, as distinct from what a reasonable person would have known or appreciated. For the most part dishonesty is to be equated with conscious impropriety. But a person is not free to set his own standard of honesty. This is what is meant by saying that the standard is objective. If by ordinary standards, the defendant's mental state would be judged to be dishonest, it is irrelevant that the defendant has adopted a different standard or can see nothing wrong in his behavior".[8]

12. There is a second class of accessory liability which can attach to a bank which receives trust property lawfully and not for its own benefit, but then deals with it in a manner which is inconsistent with the trust.[9] There is some debate[10] whether this too requires dishonesty to be shown, or is established by the unconscionability test applied in claims of knowing receipt, referred to below.

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[2] Verjee v CIBC Bank, 21.3.01.
[3] Liggett (Liverpool) Ltd v Barclays Bank Ltd [1928] 1 KB 48.
[4] Crantrave Ltd v Lloyds Bank [2000] QB 917.
[5] Shah v HSBC, 4.2.10.
[6] Barclays Bank plc v Quincecare [1992] 4 All ER 363, 376g.
[7] Patel v Standard Chartered Bank, 6.4.01.
[8] Aerostar Maintenance International Ltd v Wilson, 30.7.10.
[9] Agip (Africa) Ltd v Jackson [1990] 1 Ch 265 at 291.
[10] Lewin on Trusts 18th ed (2008) para 42-89 suggests an agent holding money for trustees will not be liable so long as he acts honestly. Compare O'Donovan on Lender Liability (2005) para 9.70 who suggests the unconscionability test in knowing receipt may well be applied.

Account operation – the receiving bank

13. Claims against a bank which has received funds to which it was not entitled can generally be grouped under the following main heads:

    a. Conversion;

    b. Liability for money had and received; and

    c. Accessory liability.

Conversion

14. When the payment is made by an instrument (such as a cheque, bill or note) collection of the cheque for a customer who is not entitled to it (or to payment of the funds to which it refers) can be a conversion for which the receiving bank is liable in damages.

15. To be the subject of a claim in conversion the debt must be embodied in an instrument such as a cheque, because conversion claims relate to chattels, not to choses in action[11] (although the damages payable for wrongful conversion of a cheque equate to the face value of the cheque, not just the value of the paper of which it is written).

16. Defences available to the bank include the following:

    a. In relation to the collection of a cheque (and analogous instruments) to which the bank's customer had no title or a defective title, the bank is not liable to the true owner if it received payment in good faith and without negligence: s 4 Cheques Act 1957. Relevant considerations will include whether the bank complied with its own internal rules, took up references when opening its customer's account, allowed rapid withdrawals after account opening,[12] or allowed a cheque crossed 'account payee' to be paid into an account other than of the named payee, or into an account which the bank had, contrary to normal banking practice, wrongly allowed someone other than the payee to open in the name of the payee.[13]

    b. That the Claimant bringing a conversion claim was contributorily negligent (a partial defence).[14]

    c. That the Claimant in fact benefited from the payment by the discharge of a liability to the payee.

Money had and received

17. Most commonly this is the basis on which money paid by mistake is sought to be recovered from the recipient bank. Money paid by mistake is generally repayable subject to the bank establishing one of the available defences.[15] The claim is not limited to the immediate recipient but may be brought against a subsequent transferee.[16]

18. Defences available to the bank receiving money paid by mistake include the following.

19. That the paying bank did not in fact pay by mistake because the payment was authorised or subsequently ratified by the paying bank's customer.[17]

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[11] OBG Ltd v Allan [2008] 1 AC 1 [94-107].
[12] Linklaters v HSBC [2003] 2 Lloyd's Rep 545.
[13] Architects of Wine Ltd v Barclays Bank [2007] 2 Lloyd's Rep 471.
[14] Banking Act 1979, s 47.
[15] Barclays Bank Ltd v W J Simms [1980] QB 677, 695.
[16] Agip (Africa) Ltd v Jackson [1990] 1 Ch 265 at 287.
[17] Lloyds Bank v Independent Insurance [2000] QB 110.

a. That the payment in fact discharged a debt owed by the payer to the customer of the recipient bank.[18]

b. That the bank received the funds as agent for its customer, accounted to its customer, and the money was paid away, before notice of the Claimant's claim. It has been said that this defence does not avail an agent who has accounted after notice of the Claimant's claim.[19] A bank does not account to its customer merely by crediting the funds to the customer's account. The money must have been paid away by the bank or the customer, before notice of the Claimant's claim.[20]

Accessory liability

20. If the recipient bank has received trust funds for its own account (for example, so as to reduce its customer's borrowing on overdraft or loan), the bank may incur liability as an accessory for knowing receipt if the bank's state of knowledge is such as to make it unconscionable for the bank to retain the benefit of the receipt.[21]

21. It remains unclear whether a bank which receives money paid by mistake automatically holds the funds on trust to repay the paying party.[22] But it probably will do if the mistaken payment was made at its request, the fund is identifiable and the recipient has notice of the claim.[23]

Debt recovery and security enforcement – some practical litigation problems

22. At every stage of the process in seeking to recover money or enforce security, lenders face practical and legal issues. This part of the talk will focus on practical issues likely to be experienced by those involved in claims for or against banks.

Obtaining the lender's papers

23. The first step in seeking to recover a debt or enforce security is to obtain the bank's file. Obtaining complete paperwork covering the entire relationship can often present its own difficulties. In practice the documentation relating to a particular transaction, customer or relationship will often comprise papers from a number of different locations across the organisation including but not limited to records from branches, regional offices, security centres and debt recovery teams.

24. Older papers may have been destroyed in accordance with the bank's document retention policies or placed in large off-site storage facilities.

25. Some files may exist in paper form, others on some form of IT system, including e-mails/archived e-mails requiring different search techniques.

26. The quality of copied or imaged documents can be an issue and it may be necessary to have some documents (especially manuscript notes) transcribed for use in court.

The right to sue

27. Most fundamentally the lender must be in a position to prove its right to sue on the debt. In order to do so, the lender must prove the terms upon which it made a facility available to its customer; that any applicable event of default has occurred and that any necessary demand has been made.

28. Proof of default or demand is essential.

[18] Lloyds Bank v Independent Insurance [2000] QB 110, 133.
[19] Agip (Africa) Ltd v Jackson [1990] 1 Ch 265 at 288.
[20] Jones v Churcher [2009] 2 Lloyd's Rep 94.
[21] BCCI v Akindele [2001] Ch 437.
[22] Fitzalan-Howard v Hibbert [2010] PNLR 11, [49].
[23] Commerzbank v IMB Morgan [2004] EWHC 2771 (Ch), [36].

a. It crystallizes the cause of action and therefore the right to start the claim;

b. It establishes the date from which time starts running for Limitation Act purposes;

c. It often establishes the date from which the lender's right to repayment of the whole of a loan accrued under a loan agreement;

d. It often establishes the date from which the lender is entitled to enhanced (or default) interest.

29. The ability to rely on any contractual event of default or letter of demand may give rise to issues as to whether the default has occurred, whether there is any implied restriction on the lender's entitlement to serve notice of default,[24] whether the demand is couched in sufficiently unambiguous and peremptory terms, and whether the lender can prove service on the debtor/mortgagor at an appropriate address.

Common difficulties when enforcing security

30. The enforceability of guarantees and third party charges (such as a mortgage by one spouse for another's business liabilities) can be the subject of challenge on grounds that the surety's consent was obtained as a result of undue influence or other wrongdoing of which the lender was on notice.[25]

31. If (as will often be the case) external advisers were involved in the taking and perfection of the lender's security, their papers are likely to be needed. In so far as client confidentiality prevents any part of their papers being made available to the lender, the lender may need to seek the surety's consent to the relevant papers being voluntarily disclosed, or if possible to issue a witness summons for the documents to be produced to the court at a pre-trial hearing.[26]

32. Careful, consideration may have to be given to the extent to which any departure from the standard "Etridge" guidelines[27] for obtaining a solicitor's confirmation of independent advice, impacts on the enforceability of the lender's security. For example, if the lender cannot produce a copy of its letter inviting the wife to nominate a solicitor, can the lender rely on a certificate signed by the wife on the mortgage or other deed confirming that she had nominated the solicitor to advise her?

33. Common defences in respect of claims under a guarantee include challenges to the validity of the guarantee on the basis that the underlying agreement has been varied or novated thereby discharging the guarantor's liability.[28] Less common are challenges on the basis that the guarantee does not comply with s.4 of the Statute of Frauds 1677.

34. It is also common to see defences based on the lender's failure to disclose material facts as to the underlying debtor's circumstances or that the liability should be shared with a third party or the principal debtor.

The impecunious debtor

35. Increasingly lenders seeking to recover both primary and secondary liabilities are thwarted by the use of one or other forms of insolvency process by the debtor / guarantor.

36. On the making of a bankruptcy or winding-up order, the lender will usually be limited to proving its unsecured claims in the bankruptcy, liquidation or administration.[29]

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[24] Concord Trust v The Law Debenture Corp [2005] 1 WLR 1591.

[25] The defence examined in Royal Bank of Scotland v Etridge (No 2) [2002] 2 AC 773.

[26] CPR r 34.3 and Khanna v Lovell White Durrant [1995] 1 WLR 121.

[27] Royal Bank of Scotland v Etridge (No 2) [2002] 2 AC 773, [79]-[80].

[28] Holme v Brunskill [1877] 3 QBD 494; Trodios Bank NV v Dobbs [2005] 2 Lloyd's Rep 588.

[29] Insolvency Act 1986 ss 130, 285 & Schedule B1 para 43.

Conclusion of a voluntary arrangement will not necessarily bring a halt to legal proceedings in the absence of an express provision to that effect in the approved proposal,[30] but any judgment obtained by a lender bound by the arrangement is likely to fall within the scope of the arrangement so that conventional avenues of enforcement will not be available.

Enforcement of securities

37. A lender which has succeeded in obtaining a judgment and order for possession of mortgaged property faces exposure to positive liabilities arising from its management of the premises and the sale process. In particular:

    a. Once in possession, the lender faces the liabilities which attach to that status, including the duty to take reasonable care to maximize a return from the property,[31] such as by letting at no less than the market rent, and to take reasonable care of the property itself, such as by taking steps to protect the property against vandals pending sale and to carry out reasonable repairs.

    b. Similarly, sale of the security must be at a proper price. This is a prime area of complaint against lenders involved in repossession sales and it is therefore essential that the lender should commission and obtain reliable valuation evidence, preferably from at least two independent sources.

38. Though lenders realising commercial or tenanted property will frequently chose to do so through receivers, precisely to avoid such potential liabilities, the lender needs to bear in mind the need not to "intermeddle" with the conduct of the receivership by giving directions or instructions to the receiver which may result on the receiver being regarded as the agent of the lender[32] and losing his status as agent for the borrower/mortgagor.[33]

Regulatory liabilities

39. When considering the liabilities which a bank or financial institution may incur, it is important not to overlook the fact that a valid complaint by, or cause of action on the part of, a customer may give rise to an additional statutory cause of action and/or to further liabilities or responsibilities owed by a bank to the relevant regulator. Liabilities owed by a bank to a regulator are distinct from those owed to the customer.

40. A retail bank may owe responsibilities to more than one regulator. The domestic retail banking industry which, at its most basic level, comprises deposit taking and the operation of current and savings banking accounts, is regulated by the Financial Services Authority, (the "**FSA**") pursuant to the Financial Services & Markets Act 2000, (as amended, the "**FSMA**")[34]. Further, the FSMA regime also regulates the sale and provision of first charge mortgages and the sale of insurance products, both of which are commonly undertaken by retail banks.

41. Detailed rules and commentary concerning, amongst other things, the structure; funding; organization; systems and controls; risk management; and general operations of banking business are contained in the FSA Handbook of Rules and Guidance[35].

42. However, a domestic retail bank which is a credit card issuer and/or which makes available secured or unsecured personal loans to its customers will need to comply with the provisions of the Consumer Credit Act, (as amended, the "**CCA**") and will owe additional responsibilities to the Office of Fair Trading, (the "**OFT**"). The OFT is the entity

[30] Alman v Approach Housing Ltd [2001] 1 BCLC 530; El Ajou v Stern [2007] BPIR 693, [33]-[34].
[31] Palk v Mortgage Services Funding Plc [1993] Ch 330,338.
[32] American Express International Banking Corporation v Hurley [1985] 3 All ER 564.
[33] Section 109(2) Law of Property Act 1925, usually reflected in the express terms of the security instrument.
[34] Sections 1 and 2, FSMA.
[35] See section 138 FSMA and for the handbook: http://fsahandbook.info/FSA/index.jsp

responsible for the monitoring and enforcement of the CCA and of course, personal loans and credit cards fall to be regulated under the CCA.[36]

43. Statutory obligations will often spring from the same facts which gave rise to the liability to the customer in the first place. By way of example, a customer will have a cause of action against their bank for breach of mandate in circumstances where a bank has wrongly paid away monies from the customer's account without authorization in accordance with the terms of the relevant account mandate.

44. We have already seen that in the circumstances described above, the customer will have a claim against the bank for breach of contract and will be able to claim damages, subject to the availability to the bank of any defences.

45. In addition to the customer's common law cause of action, a separate statutory right of action under the FSMA is also conferred on the customer in the same situation. Briefly, the FSMA confers a right of action on an "individual" (broadly, a person who is not acting in the course of a business) who suffers loss as a result of contravention of a rule made pursuant to the FSMA[37]. The statutory cause of action is expressed to be subject to the relevant defences and other incidents applicable to breach of statutory duty[38].

46. Therefore, in circumstances where the bank has made a payment in breach of mandate, the FSA Handbook contains statutory rules about a bank's liability for unauthorized payments. The FSA Handbook provides that[39]:

> "*Where a banking customer denies having authorised a payment, it is for the [bank] to prove that the payment was authorised. Where a payment from a banking customer's account was not authorised by the banking customer, a [bank] must, within a reasonable period, refund the amount of the unauthorised payment to the banking customer and, where applicable, restore the banking customer's account to the state it would have been in had the unauthorised payment not taken place*."

47. Accordingly, where there has been a breach of mandate and the bank breaches its statutory duty to restore the customer's account to the state in which it would have been had the un-authorised payment not taken place, the customer will have both a common law and statutory right of action.

48. It is important to note however that specified FSMA rules are expressly stated not to give rise to a statutory cause of action on the part of an individual. For example, the FSMA expressly states that an individual does not have a statutory cause of action for damages in cases where there is a breach of the rules relating to the maintenance by banks of financial resources[40]. Further, a breach of many of the rules relating to the maintenance by banks of adequate systems and controls will not give rise to a cause of action by an individual in circumstances where there is a breach of those rules[41]. The only entity which can sanction a bank for breach of this grouping of rules is the FSA which has a range of remedies available to it.

49. The position is similar in relation to the Consumer Credit Act regime. The CCA contains direct remedies for the consumer in the event of a breach of specified provisions of the CCA. For example, a failure on the part of a lender to provide, prior to conclusion of the contract, pre contract information[42] to the customer in connection with a prospective CCA – regulated personal loan agreement will mean that the ensuing loan agreement is

[36] Section 9 Consumer Credit Act 1974, as amended.
[37] Section 150(1) FSMA
[38] Section 150(1) FSMA
[39] See FSA Handbook of Rules & Guidance BCOBS 5.1.11
[40] Section 150(4)(b) FSMA
[41] FSA Handbook (SYSC) 1.4.2
[42] Section 55(1) Consumer Credit Act 1974

"improperly executed" for the purposes of the CCA[43] and enforceable against the customer only upon a Court Order.[44]

50. Nevertheless, the potential regulatory consequence would be that if the OFT's monitoring of the relevant lender revealed a high level of customer complaints regarding a failure to provide pre-contract information; or if the OFT otherwise uncovered systemic failures by a lender to adhere to the requirements of the CCA, this might cause the OFT to consider whether the lender was a "fit and proper person" [45] to hold a Consumer Credit licence. Where such concerns arise, the OFT has a range of sanctions available to it, including the ability to attach conditions to a lender's CCA licence[46], or the ability to withdraw the licence altogether.[47]

51. Consequently, the key lesson is that a liability owed by a bank to a customer can rarely be looked at in isolation. The potential regulatory consequences of any breach of contract or breach of duty should always be considered and in particular, the existence of an additional statutory cause of action should be evaluated where appropriate.

52. As an important, final point to note, the regulatory landscape is in flux. Both the FSA and the OFT are likely to be disbanded. A Treasury consultation paper entitled 'A new approach to financial regulation: judgment, focus and stability', outlines preliminary plans for two new regulatory bodies: the Prudential Regulation Authority ("**PRA**") and the Consumer Protection and Markets Authority ("**CPMA**").

53. The PRA has been tasked with 'promoting the stable and prudent operation of the financial system' in order to minimise systemic risk associated with any future bank failures and is set to oversee deposit-taking institutions. Meanwhile, it is intended that the CPMA will regulate the conduct of firms towards retail clients which may include adoption of many of the OFT's and FSA's current retail responsibilities. Watch this space…..........

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[43] S. 55(2) Consumer Credit Act 1974
[44] S.65(1) Consumer Credit Act 1974
[45] S. 25 Consumer Credit Act 1974
[46] S. 33A Consumer Credit Act 1974
[47] S. 32 Consumer Credit Act 1974