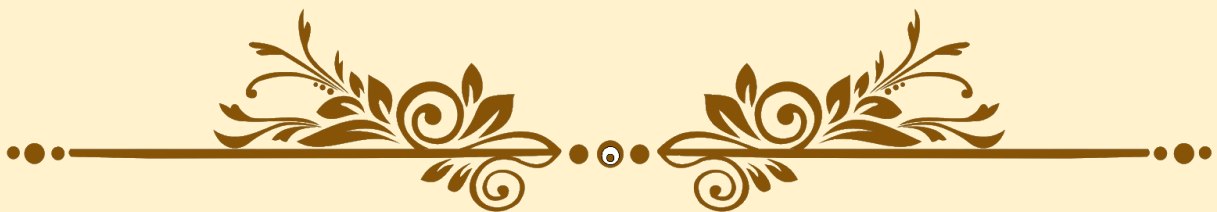


BANKER'S RIGHT TO SET-OFF IN INDIA – FROM THE JUDICIAL LENS

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Introduction

The right to exercise set-off gives an authority to the lender to seize the deposits made by the debtor in case of a default on the loan. It can also be referred to as a mutual settlement of debt between a creditor and a debtor through off-setting the transactional claims. This actively demonstrates the creditors can derive a comparatively increased amount than going in bankruptcy proceedings against the debtor. However, the tools should be appropriate so that the resolution between the two parties like the debtor and creditor facilitates financial stability, ensures consumer protection and limits the moral hazards by promoting market efficiency. The article attempts to discuss the rights of bankers in exercising the set off by placing reliance on multifaceted judicial pronouncements and the potential issues involved in the same.

The Perspective

The relationship subsisting between the banker and his customers is dependent upon the nature of services provided by the particular banker. The core business of a bank is mainly accepting deposits and lending or investing in addition to its primary transactional functions, . The relationship between the banker and customer can be understood with the help of the following diagrammatic representation.

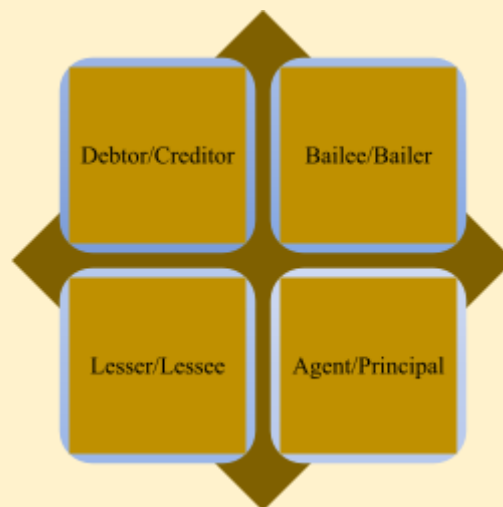


Fig 1.1 Diagrammatic representation depicting the relationship between a Banker and Customer

Understanding who is a customer?

There is no proper definition in law for understanding the phrase ‘customer’ of a bank. Generally, it has been presumed that a person who has an account in a bank is a customer. According to the views expressed by banking experts and judicial pronouncements, the timeline for which the account had been maintained with the bank is considered as a factor to understand the term of customer. To constitute a customer, *Sir John Paget* reiterated that there should be the presence of a course or habit of dealing like regular banking businesses. This particular view as propounded for the definition of a customer with the bank is significant on the cornerstone of duration of dealings executed between the banker and a customer, broadly referred to as a ‘duration theory.’ The point envisaged by this theory is that, a person does not automatically become a customer of the bank on the opening of an account, instead he must

have been familiar over a period of time with a banker to deal, before he is designated as a customer. However, according to *Dr. Hart* “a customer is a one who has an account with a banker for whom a banker habitually undertakes to act as such” and affirming this particular point of view the Kerala High Court observed in the case of *Central Bank of India Limited Bombay v Gopinathan Nair and others*¹ held that a customer is essentially a person who is habitual and resorts only to a particular place or a person to do business. Hence, a person who creates a bank account under his name and for whom the bank undertakes to provide certain facilities in the capacity of a banker is considered to be a customer.² The account need not necessarily be operated for some period of time. The essential ingredient in this aspect is even the presence of a single account is sufficient to characterise the person as a ‘customer.’

Relationship as Debtor and Creditor

Upon the activity of opening an account with the bank, the banker occupies the position of a debtor. It is important to note that the banker is not a depository or Trustee of the money provided by the customer because the money owed by the banker Assume is the characteristic of a debt which is due from the side of the banker to the customer and therefore the banker does not accept depositors’ money on such tabulated conditions. In furtherance, the customer has a right to demand his money back because the money and the banker are under the obligation to repay the same. However, the situation comes to a reversal mode when the banker becomes the creditor in a situation where the customers’ account is overdrawn.

Relationship as Bailor and Bailee

In accordance with the provisions of the Indian Contract Act 1872,³ the relationship between a banker and their customers is analysed from the angle of bailor and bailee. The provision

¹ *CBI Limited Bombay v Gopinathan Nair and others*, AIR 1979 Ker 74.

² *Tannan, M. L. (Mohan Lal), 1885-1968. (2008)*. Tannan’s banking law & practice in India. New Delhi: Lexis Nexis Butterworths Wadhwa.

³ S 148 of The Indian Contract Act 1872.

encapsulates the definition of bailment, bailor, and bailee by stating that a bailment is a delivery of goods by one person to another for some purpose which is agreed between both the parties in the form of a contract. For instance, consider a situation in which a customer is willing to avail the safe custody facility for the certain agreed period of time and for the aforesaid period the customer makes the payment and the applicable charges for the same, in this case, the banker (*who is now Bailee*) shall return the contents of the sealed safe custody box to the bailer upon the fulfilment of the agreed purpose of the bailment.⁴

Relationship as Lessor and Lessee

The relationship of lessor and lessee arises when the safe deposit locker account facility is availed by the customer.⁵ In this, the bank permits the respective locker account holder the right to use the space against the payment of an amount as a consideration thereof.

Relationship as Agent and Principal

The relationship between a Banker and customer takes the form of agent and principal also because the bank undertakes to act as an agent of his customer and for the convenience of his customers, he is indulged in various agency functions, for instance, he purchases or sells the securities on behalf of his customers, collect cheques on behalf of the customer and makes payment of various dues of his respective customers for example the insurance premium. Therefore, in this particular respect, it has been observed that the functions which are performed by the banker are of diverse nature and intended for the benefit of the customers which consequently creates a relationship of agency between both the parties.

Set-off in General Banking Parlance

⁴ *United Commercial Bank v. Hem Chandra Sarkar* 1990 AIR 1329.

⁵ S 105 of the Transfer of Property Act 1882.

It is important to understand the roots of the Banking set off which is usually considered as an offshoot of the venerable banker's line which fundamentally arose as a part of the Merchant law and was subsequently absorbed into English common law.⁶ The general rule which has evolved is that a bank has a lien on all property that is in his possession that belongs to a customer for balance which is due to the bank from such customer in the ordinary course of business. The case of *Aurora Mal Durga Das*⁷ explains bank's right to set-off as-

'The court observed that the right of a Bank to apply a deposit to an indebtedness due from the depositor comes out from the concept of right of set-off. The right of set-off exists between persons occupying the relation of debtor and creditor with mutual demands, mutuality being the essential ingredient of set-off between the same parties.'

The debtor-creditor relationship is created when the depositor opens a demand deposit or general account with the bank, the bank has legal lien on any money deposited and a bank in the position of a creditor can rely on such an amount for recovery of any money due from a customer, of which generally the customer is not aware. This particular practice of peremptorily debiting the customer's account before proof of his indebtedness to the bank is one of the examples of how banking set off has diverged from the equitable principles on which it was founded ostensibly.⁸

The right to set off arises on account of circumstances involving death, incapacity or insolvency of a customer, liquidation or insolvency of the company, receiving a notice of assignment of a customer's credit balance, a garnishee order, and receiving a notice of a second mortgage over a security charged to the bank.

From the angle of Consumer Protection

⁶ *Brandao v. Barnett*, 136 Eng. Rep. 207 (C.P. 1846).

⁷ *Punjab National Bank Ltd v. Arura Mal Durga Das* AIR 1960 Punjab 632.

⁸ *Smith v. Security Bank & Trust Co.*, 196 Ark. 685.

In the cases involving banking transactions, it also becomes imperative to protect the interests of the consumers. The banker is responsible for safeguarding the interest of the customers who have kept their property as custody with the bank, the bank cannot unilaterally or arbitrarily convey the money of the depositor from his account to the bank, it amounts to a deficiency in the services on the part of the bank.⁹ The banks should be serious and solicitous in the banking transactions because negligence in its duty would not only be detrimental to an individual but could result in economic slowdown too.¹⁰

The approach of the courts has always been in the direction of protection of the interest of the consumers at large which is also signified in the case wherein the court propounded that the beneficiary under a bank guarantee is also a consumer and the bank was ordered to make good the loss for the shortfall in its functioning.¹¹

Taking reference from Clayton's Rule

The rule derived from *Clayton's* case¹² is fundamentally based on a legal fiction which states that if an account is in credit, then the first sum paid-in will also be the first sum to be expelled out and in some circumstances if it is found that the account is overdrawn, then the first sum paid is allocated to the earliest debit on the account which caused the account to be overdrawn. The rule applies in situations where there is a running account between the parties as for instance, a banker and a customer. The rule derives its significance from the fact that in terms of order of their dates, the final accounts are made up then the debits and credits are set off against one another therefore, it leaves only the final amount of balance which is to be recovered by the creditor from the debtor. However, a point that requires due consideration is the fact that the rule is a mere presumption and its applicability differs according to the facts and circumstances of each case. In the case of *Commerzbank Aktiengesellschaft v, IMB Morgan plc, and others*¹³ the court decided not to resort to this rule keeping in view the facts

⁹ *Dilip Madhukar Kambli v. Nilesh Vasant Borkar and Ors* 1991(1) CPR 571.

¹⁰ *N.Sahadevan v. Manager, Syndicate Bank* 1991(2) CPR 617 (SCDRC- Kerala).

¹¹ *Union Bank of India & Anr., v. M/s. Seppo Rally OY & Anr.* 1996 (2) CPR 221 (NC).

¹² *Devaynes v Noble* (1816) 35 ER 781.

¹³ *Commerzbank Aktiengesellschaft v, IMB Morgan plc, and others* (2004) EWHC 2771 Ch.

of the case wherein it was found that the sums present in the bank account were derived from the victims of Nigerian advance frauds.¹⁴ Though the rule is antique, it is generally applicable in the situations where tracing of claims is required to identify if any fraudulent activities took place. The rule is based on a substratum of principles of equity and it forms an exception in the cases where it is found that there is an amalgamation of a fiduciary's money with the trust money in a private account.¹⁵ However, if it is found that the beneficiary's fund is mixed up with a volunteer then the rule takes its path for determining their respective entitlements.¹⁶

Therefore, taking reference from Clayton's case, if the customer has maintained a single account and he is found indulged in cases wherein he deposits and withdraws money on a frequent basis, then the pattern of credit entry and debit entry in a sequential manner will be followed as per the Clayton's case this particular rule derived from the case is of immense practicability to the bankers. In the circumstances involving the issue of death, insolvent partner or retirement of a partner from firm the incumbent debt is adjusted or set-off by the subsequent credit made in the account. In this scenario, the banker is forbidden from exercising his right to claim from the assets of the person who is retired, insolvent or dead.

Therefore, to avoid such a loss, the bankers normally tend to close the old account and switch to a new account with its reconstituted members. Therefore, it is evident to note that the banker has a right to combine accounts unless otherwise is provided in contracts, wherein a customer possesses one account in debit and another in credit.¹⁷

Legal Clutches for a Paying Banker

The law relating to the payment of a customer's cheque by a Banker and protection accorded to the banker is governed by the Negotiable Instruments Act 1881.¹⁸ Prior to exercising the right of set-off the banker must take into consideration the following factors-

¹⁴ *Ibid.*

¹⁵ Re MacDonald (1975) Qd R 255.

¹⁶ Re Diplock (1948) Ch 465.

¹⁷ *State Bank of India v. Madhya Pradesh Iron & Steel Works Pvt. Ltd., Raipur* AIR 1998 MP 93.

¹⁸ S 31 of the Negotiable Instruments Act 1881.

- a. The value of security which relies on the solvency of the debtor and his right to set-off.
- b. The notices pertaining to assignments must be served by the banker to the respective debtors, who must acknowledge the receipt and confirm his right to set-off.

The following flow-chart enlists certain conditions for the bankers to exercise their right to set-off.

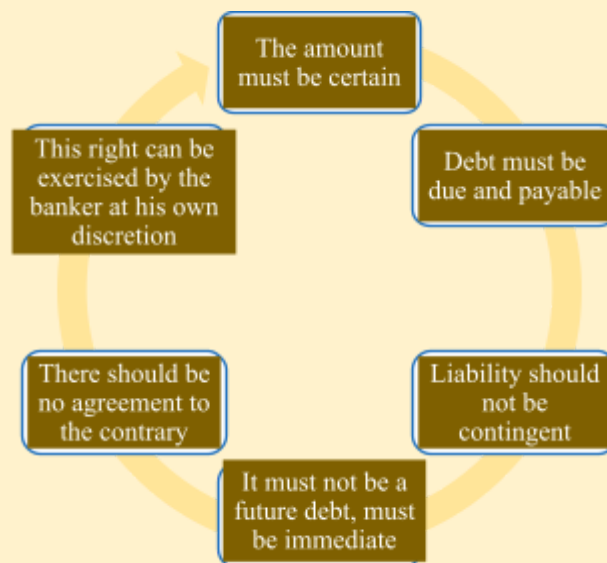


Fig 1.2 Conditions for bankers right to set-off

The exercise of the Right of set-off in real sense

It is important to note that there is no requirement of approval of the legal proceedings because the banker has the right to combine the accounts and there is no necessary condition of the express consent of the customer for the right to set-off. This right is exercised by the bank as a matter of custom and business practice and it becomes operative as soon as an account is opened by a customer. This act confers a contractual obligation between the parties which is driven by a letter of the set-off that enlists certain specific clauses as agreed between the bankers and customers. The nature of the claim against which the right to set-off is

exercised may be unconditional, liquidated, unliquidated, contingent, future, or existing.¹⁹ Pragmatically speaking, the right to set-off confers two types of rights upon the bank, which is first, there will be no withdrawals made by the customer if the customer is liable to the bank against some amount of money and furthermore, it facilitates banker to debit against the balance accrued that is due to himself.²⁰

Potential Issues involved

There is a critical concern which crops up on the bankers right to set off particularly, in the case of joint accounts. In case of joint accounts, the bank cannot set off a debt due from one person against the joint account. In addition, the bank is under no obligation to transfer money from the credit balance of a joint account for the realisation of the debit balance of an individual account of one of the holders of the joint account. If such a circumstance arises then, the other holder of the joint account would come into the shoes of a guarantor for the other partner without even knowing the terms and conditions of the debt. This situation can be averted by executing an express contract between the parties holding joint account to the effect that one of the holders can act as a guarantor to the other in personal capacity.

In the case of *Simla Banking and Industrial Company Limited*,²¹ the contention put forth by the appellant was that the bank had no right to adjust the amount of the fixed deposit in the absence of a claim and in a circumstance where the liability was not quantified yet. Further, it was submitted that the bank could not act on the basis of any pledge which is alleged to have been created by the husband of the appellant of the fixed deposit receipt without the consent of the appellant. The court in this particular case stated that the debt in the form of a fixed deposit receipt was that of a bank to the joint account holders and the bank cannot set off a debt which is due from one of the joint account holders against such a joint account. Reliance was placed on Sheldon and Fidler's practice and the law of Banking²² wherein it was stated

¹⁹ LawTeacher. November 2013, *A Bankers Right to Set Off Money*. Available from: <https://www.lawteacher.net/free-law-essays/contract-law/a-bankers-right-to-set-off-money-contract-law-essay.php?vref=1> [Accessed 26 July 2021].

²⁰ *Ibid.*

²¹ *Simla Banking and Industrial Company Limited v. Bhagwan Kaur* AIR 1928 Lahore 316.

²² Sheldon, Fidler, Freeman, Sheldon and Fidler's Practice and Law of Banking, McDonalds and Evans, 1982.

that pragmatically the bank should not enter into an agreement to lend money to the parties to joint account holders either through the means of an overdraft or in any other way without obtaining the undertaking from each of the parties to be jointly liable for the payment of the loan. In such a circumstance the banker has no right to set off the credit balance in the joint account except in the respect of another joint account of the same parties.

In the case of *Anumati*,²³ a fixed deposit receipt was issued by the bank in the name of the husband and his wife which was payable either to them or to the survivor. The wife filed a suit against the bank for the recovery of the deposit however, the bank rejected the claim and cited that the husband was severely indebted to the bank. The defence provided by the bank was negated by the court and the court held that the bank cannot appropriate the said amount of the fixed deposit which was due from the husband either in the eyes of law or equity. The bankers can combine one or more accounts of the same customer for exercising their right of set-off, however they cannot combine a personal account of a customer with that of a joint account. This negation of act is based on the principle of mutuality²⁴ which is an essential ingredient and in the case of a personal and joint account, mutuality is absent and it would not be in equity to reduce the liability of one account holder without seeking the consent for the same with the beneficiary. An important point that should be noted is the fact that the right to set off cannot be exercised by the bank in its absolute sense; it can only be effectuated when the bank has to receive money from one particular customer.

Conclusion

One of the important dimensions of banking operations is the right to exercise set off. This right can be exercised by the banker when the money owed to him is a certain sum which is due and provided there is no agreement whether express or implied in contrary. The term set off generally ascribes the meaning of combining two or more accounts for the final settlement of accounts. Speaking in other terms, it is generally a practice where the bank recovers its

²³ *Anumati v. Punjab National Bank* AIR 2005 SC 29.

²⁴ *Indian Bank, Rasipuram v. Sri Annapoorna Finance, Rasipuram* (2002) 1 MLJ 125.

loan which is due to the debit of the deposit account of the borrower. In absence of any contractual obligation between the parties while exercising the right is mostly applicable to the current accounts of the customers. The banking set-off is fundamentally an accepted practice which takes place for centuries, therefore the set-off is considered to be an important tool for the creditor and it will continue to be the same till it doesn't cast any debilitating effect on the interest of the consumers. The creditors are also entitled for right to compensation in the cases where they are not even receiving a minimum amount than what they would have derived from the liquidation of a firm under the respective insolvency regime. Therefore, the resolution should be to carve out a middle point and protect the interest of both the groups involved in the issue.

