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DISPUTES

A bank's duties to non-customers – clarified or extended?

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A bank's duties to non-customers

When money is deposited into a bank account, it becomes the property of the bank. This enables the bank to pool its funds to grant credit and make loans – in other words, to conduct the business of a bank. In return for ownership, the bank undertakes a personal obligation to pay out the credit balance on the account, on whatever terms have been agreed. This obligation arises from contract and is owed to the account-holder, except when it isn't.

What is the position when the account-holder has no entitlement to the money deposited into the account – for example, an erroneous payment to an incorrect account, or stolen funds, or money paid in by or for the benefit of another person? Does the bank acquire an obligation towards the party who *is* entitled to the funds? If so, on what legal basis? These were among the questions that the SCA grappled with in the recent case of *Firstrand Bank Ltd v Spar Group Ltd*.[1] The judgment provides some clarity, but also leaves some questions unanswered.

Franchisee retailer defaulted on the terms of its franchise agreement

The facts were that a franchisee retailer defaulted on the terms of its franchise agreement with the franchisor, Spar – which in turn obtained a provisional order in a Magistrates Court perfecting a notarial bond of security it held over the assets of the franchisee. The terms of the notarial bond, as perfected in the provisional order, entitled Spar to take over the franchisee's three retail outlets (one retail grocery and two liquor stores) and run them at its (Spar's) own cost and for its own benefit. This Spar duly did. During the period pending the provisional order being made final, which ultimately never happened, Spar and the franchisee acted in accordance with an unsigned "short term business lease" which regulated the interim position.

One crucial area where the parties did *not* agree, related to the franchisee's bank accounts, which were linked to the electronic payment points at the three outlets. Spar naturally wanted to be placed in control of the franchisee's bank accounts while it traded for its own benefit, or to have the accounts changed. The franchisee did not cooperate, and the bank was not prepared to make any changes without the franchisee's agreement or a court order – the provisional order apparently did not include any account-freezing relief. The bank was however made aware of the provisional order and of the interim arrangement, and in fact expressed concern in internal e-mails that it had, in effect, been left without income to service the debt facilities extended to the franchisee. The bank thus understood that the franchisee was not entitled to the funds deposited into the accounts from the time Spar stepped in.

While Spar ran the franchisee's business for its own account, credit card payments by customers continued to be made into to the franchisee's three bank accounts. Spar was unable to access this money, although entitled to it, due to its inability to gain control of the franchisee's accounts. In addition, Spar was (at least at first) only aware of one account – the bank having taken a deliberate decision not to reveal to Spar the existence of the two accounts that had not been mentioned in the court papers. About two weeks after Spar had taken over the franchisee's business, the bank informed Spar that the "account", i.e. the one that Spar was aware of, had been frozen.

Spar continued to operate the franchisee's business for its own benefit. At the same time, unknown to Spar, the bank had been setting off the money deposited into one account (the one that Spar was aware of) against debt owed to it by the franchisee. In addition, the controlling mind behind the franchisee, Mr Paolo, withdraw substantial funds from the other two accounts, and appropriated them. The bank took no steps to prevent Mr Paolo from doing so. Predictably, this resulted in Spar suing the bank, both for the amounts it had purported to set off against the franchisee's bank debt, as well as for the money withdrawn by the franchisee.

Supreme court of appeal

The SCA had no difficulty in finding for Spar in relation to the money that the bank had purported to set off. This was on the basis that in order for set-off to operate, there had to be two opposing debts, namely a debt owed by the franchisee to the bank (the debt facility), and a debt owed by the bank to the franchisee (the credit balance in the account). The latter debt did not exist, since the money standing to the credit of the relevant account was not owed to the franchisee. Therefore, there could be no set-off.

Who, then, was the credit balance on the account owed to, if not to the account-holder? And how was such obligation acquired, if not in contract? The SCA found the answer in the law of enrichment: given that the bank became the owner of the funds deposited into the account, it would be enriched at the expense of the party entitled to the money, namely Spar, if a corresponding obligation to pay the money to Spar did not simultaneously arise.

As far the as money withdrawn by Mr Paolo was concerned, the SCA found that the bank had a legal duty to take steps to prevent harm to a third party in circumstances where the bank knew that the third party, and not its account-holder, was entitled to the money deposited. Mr Paolo had misappropriated the money he withdrew, and the bank, by failing to discharge its legal duty to prevent this, had effectively enabled him; it had thus become a co-wrongdoer with Mr Paolo, and was liable in delict on that basis.

The judgment thus clarifies that a bank that knows of its account-holder's lack of entitlement to money deposited in the account can indeed acquire obligations and duties towards the third party that is entitled to the funds. But certain questions are left hanging, such as: what if the bank does *not* know of its account-holder's lack of entitlement, or who is entitled to the funds? Can its lack of knowledge alter the fact that it is enriched? Has the so-called "freezing order" now been rendered superfluous, if a bank is now required, in effect, to freeze a bank account merely upon being informed of the account-holder's lack of entitlement to deposits? And what standard of assurance is a bank required to insist upon as constituting evidence of such lack of entitlement – will only a court order suffice? Also, given that the SCA found that the bank's representation to Spar that the "account" had been frozen was a misrepresentation because the bank failed to inform Spar of the two further accounts that had *not* been frozen (because they were not mentioned in the provisional order), are banks now to accept that they have a potential duty of disclosure towards third parties that overrides their obligations of confidentiality towards their own customers? It is difficult to see on what basis the bank could have acquired an obligation to alert Spar to the existence of further accounts held by its customer, in the absence of any court order to that effect. Until the position is clarified, banks could be placed in a difficult position when situations of this nature arise.

In the meantime, banks and other deposit-taking institutions should be alert to the possibility of attracting liability towards parties with whom they have not contracted and should ensure that they have adequate policies and procedures in place to mitigate their risk in relation to the handling of contested funds.

More from the dispute resolution practice: The requirements for Rescission Applications, restated.

by Pierre Burger, Director

[1] 2021 (5) SA 511 (SCA)

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