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A bank's right to set-off and their duties towards third parties

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- It is well known that banks play a critical role within the commercial sphere by, *inter alia,* accepting deposits from the general public and facilitating borrowing through the advance of loans to customers. Central to the functioning of banks, is the fact that ownership of monies deposited by customers into their banking accounts held with a bank, resides with the bank. It is as a result hereof, that a bank enjoys a real right of ownership over the deposits held by it, which enables such bank to extend loans to customers, without the participation and/or need for any form of consent from the customers to which the deposits relate.
- Accordingly, it is well established in law that, by virtue of the contract between a bank and its customer, a customer in the normal course merely acquires a personal right in respect of any amounts standing to its credit with a bank, and the bank incurs a corresponding personal obligation to the relevant customer. It is equally established that a bank may discharge such obligation towards its customers, by either paying an amount to the customer, paying an amount to a person designated by the customer or by applying set off (to the extent permissible). Our focus in this article is on the third mechanism, namely set off.
- Set off can be applied when two parties are mutually indebted to one another and both such parties' debts are liquidated, due and payable. Within the banking environment, a bank may set off a customer's indebtedness to the bank (if any) against such customer's claim against the bank arising from the credit balances held in such customer's account with the bank. Mutuality of the debt (that is, that the debts must be due as between the same parties) is accordingly of vital importance, as set off against a customer's debts cannot occur where the customer itself has no claim against the bank.
- In the recent decision handed down in the matter between *FirstRand Bank Limited and the Spar Group Limited*[1] on 18 March 2021, judges Cachalia, Dambuza and Makgoka JJA concurring with judges Sutherland and Unterhalter AJJA, (the "**decision**"), which related to an appeal from the Gauteng Division of the High Court, Pretoria, in the matter of *Spar Group Limited v FirstRand Bank Limited*[2], the Supreme Court of Appeal ("**SCA**") was required to consider certain issues relating to, amongst others, a bank/customer relationship, the duties of a bank with regards to third parties and a bank's ability to apply set off. This decision forms the basis of our analysis below.

The findings of the SCA

- In the decision, the SCA was confronted with a unique set of facts involving FirstRand Bank Ltd ("**Bank**"), its customers Umtshingo Trading 30 (Pty) Ltd ("**Umtshingo**") and Central Route Trading 30 CC (collectively, the "**Customers**"), as well as a third party, namely the Spar Group Ltd ("**Third Party**"). In summary, the Third Party conducts a business as a franchisor of the Spar brand of retail grocers and the Tops brand of liquor vendors. Umtshingo, one of its franchisees, defaulted on its obligations under their franchise agreement with the Third Party, pursuant to which the Third Party obtained a provisional order allowing it to perfect its security under the franchise agreement. As a result hereof, the Third Party was authorised to take over Umtshingo's business as well as the business conducted by Central Route Trading 30 CC and to run these businesses for their own account.
- At the outset, and as a consequence of the Third Party perfecting its security under the franchise agreement concluded with Umtshingo and thereby essentially taking over the operation of the business conducted by the Customers pursuant to the terms of the franchise agreement, it is pertinent to point out that certain monies which were deposited into the Customers' accounts with the Bank included monies which were rightfully owing to the Third Party, which revenue was generated during the period that the Third Party was in control of the Customers' businesses. The rationale for payments being made into the Customers' accounts by the Third Party is

addressed in further detail in the decision. Despite knowing that certain of the monies standing to the credit of the Customers' accounts belonged to the Third Party, the Bank proceeded to set off the Customers' debts which were owing to the Bank against the credit balance in the Customers' accounts, whilst knowing that the Customers had no rightful interest or claim to the funds. In addition, the Bank failed to prevent the Customers from making withdrawals from the Customers' accounts thus thereby allowing the Customers to effectively disburse part of the Third Party's funds standing to the credit of the Customers' accounts.

- For purposes of this analysis, we have limited our discussion to three specific issues which arose for consideration from the facts set out in the decision, as well as the relevant findings of the SCA with reference to such issues. The issues are as follows:
    - whether the Bank was entitled to set off the Customers' debts to the Bank against amounts standing to the credit of the Customers' accounts held with the Bank, in circumstances where the Bank had knowledge that the Third Party (and not the Customers) had a claim/entitlement to the funds in such bank account;
    - whether the Third Party had a claim against the Bank for the credit balance in the relevant bank account; and
    - whether the Bank owed a legal duty to and was liable to the Third Party, for allowing the Customers to disburse the Third Party's funds standing to the credit of the bank account, where the Bank had knowledge that the Customers had no valid claim to those funds.
- In relation to the first issue, the SCA held that although it will ordinarily be the case that when a customer makes a deposit into their bank account, the customer will have a contractual right to claim payment of the credit balance in such bank account, this will not always be the case. A good example here will be in instances where a customer acts as the agent of a third party. In such circumstances, the customer itself will have no personal right to claim the credit balance in the bank account. Instead, the principal (on whose behalf they are acting) will have a claim against the bank. Similarly, where a customer, by agreement, permits a third party to utilise its bank account, the agreement may provide that such third party will acquire the right to claim the credit balance standing to the credit of the bank account. Furthermore, where funds are paid into a bank account in error or stolen money is deposited into the bank account of a customer, the customer into whose account such money is paid and/or deposited will similarly have no entitlement to such funds.
- Accordingly, in instances where a customer does not have a claim against the bank, the bank may not knowingly set off such customer's indebtedness against the credit balance in such customer's accounts held with the bank. This is so as set off contemplates extinguishing a debt reciprocally, and for this purpose the debts must be due as between the relevant parties in issue. In circumstances where there is an agreement subsisting between a bank, its customer and a third party depositor, pursuant to which deposits made into an account give rise to an obligation by the bank to pay any credit accruing to such account to the third party, the bank will not be able to set off any indebtedness of its customer to the bank against the bank's indebtedness to the third party. The reason for this is that no mutuality exists as the debts are not due as between the same parties.
- In the decision, the Court was of the view that the monies which were deposited into the Customers' accounts were as a result of the Third Party conducting trading activities relative to the franchise agreement concluded with Umtshingo and accordingly the Customers had no claim to the proceeds. The Customers had no entitlement to the funds paid into their bank account held with the Bank, being the proceeds of the business conducted by the Third Party and the Bank was aware that the funds being deposited were pursuant to activities being conducted by the Third Party.
- For the above reasons, the SCA held that the Bank could not apply set off. The Customers had no personal right against the Bank to the funds credited to their accounts, which monies were derived pursuant to deposits made by activities undertaken by the Third Party and accordingly the Bank cannot contend that the Customers' indebtedness to the Bank was set off against the Bank's indebtedness to the Customers, as the Bank owed no such debt to the Customers.
- The second issue for determination was whether the Third Party had a claim against the Bank. The SCA answered this in the affirmative and held that the Bank had a duty to pay the Third Party on account of the Bank's unjust enrichment. As indicated above, a bank becomes the owner of funds after a deposit is made with it. As such, where a bank has no liability towards its customer in respect of deposits made, the bank becomes enriched. In such circumstances, the bank owns the deposits and its assets have concomitantly increased at the expense of the third party whose funds were deposited. Consequently, the third party is impoverished. The SCA held that this unjust state of affairs could not be countenanced, and necessitated the granting of an order for the Bank to make payment to the Third Party.
- Lastly, as to the third issue, the SCA held that a customer who knows that it has no entitlement to money deposited into its bank accounts commits theft to the extent that it makes any disbursements of money from such accounts that it is not entitled to. Additionally, a bank which is aware that a third party has deposited funds into its customer's bank account and is aware that its customer has no legitimate claim to the funds is under a duty to take steps to prevent harm to the third party by way of the

misappropriation of those funds by its customer. Failure to prevent such harm will render the bank a joint wrongdoer, in respect of such customer's theft. On this basis, the SCA held that the Bank owed a legal duty towards the Third Party and was liable for the loss suffered as a result of the Customers' disbursements that were enabled by the Bank.

Conclusion

The judgment in *Firstrand Bank Limited v the Spar Group Limited* goes a long way in clarifying the nature of a bank/customer relationship, a bank's legal duties towards third parties as well as a bank's ability to apply set off. It is important to bear in mind that set off is only available where a mutuality of debts exists between the parties. A bank may simply not apply set off in circumstances where it has an obligation to a third party and not its customer. Secondly, a third party who is entitled to funds held by a bank may claim the return of such funds from the bank in circumstances where the bank's customers have no legitimate claim to the funds held. This stems from the unjust enrichment of the bank at the expense of the third party. Finally, banks are reminded that they are under a legal duty to take steps to prevent harm to third parties that may arise through the misappropriation of funds by its customers.

[1] 1334/2019 [2021] ZASCA 20 (18 March 2021).

[2] *Spar Group Ltd v FirstRand Bank Ltd* 2017 1 SA 449 (GP).



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