

## WHAT IS BANKING LAW?

Banking law is not a discrete area of law like contract or torts. It conveniently describes, however, the collection of legal principles which impact on banking transactions and on the banker-customer relationship. In that sense, the activity of banking is the location at which a diverse range of legal principles intersect which we call banking law.

## SOURCES OF LAW

**1. The Constitution** - This is a body of the basic rules and principles by which a society has resolved to govern itself or regulate its affairs. It contains the agreed contents of the political system. It sets out the basic structure of government.

**2. Legislation/statute/acts of parliament** - This is law made by parliament directly in exercise of the legislative power conferred upon it by the Constitution. The product of parliament's legislative process is an Act of Parliament e.g. banking Act.

**3. Delegated legislation** - Although Section 30 of the Constitution rests the legislative power of the republic in parliament, parliament delegates its legislative power to other persons and bodies. Delegated legislation is also referred to as subsidiary (subordinate legislation). It is Law made by parliament indirectly.

**4. Common law** – It may be described as a branch of the law of England which was developed by the ancient common Law Courts from customs, usages and practice of the English people. These courts relied on customs to decide cases before them thereby giving such customs the force of law.

**5. Equity** – It may be described as that branch of the law of England which was developed by the various Lord Chancellor's courts to supplement the common Law. It was developed to mitigate the harshness of the common Law.

**6. Case law/judge – made law** – This is law made by judges. Judges make law when they formulate (enunciate) principles or propositions where none existed or in doubtful situations, which are relied upon as law in subsequent similar cases.

## STATUTORY DEFINITIONS OF A BANK,

Section 2 of the Banking Act Cap 488 Laws of Kenya defines a Bank to mean a company which carries on or proposes to carry on banking business in Kenya and it includes the co-operative bank of Kenya but excludes the Central Bank of Kenya.

Banking business is then defined under Section 2 of the same Act to mean

(a) The accepting from members of the public of money on deposit repayable on demand or at the expiry of a fixed period or after notice.

(b) The accepting from members of the public of money on current account and payment on and acceptance of cheques.

(c) The employing of money held on deposit or on current account or any part of it by lending, investment or in any other manner for the account and at the risk of the person so employing the money.

### **REGULATION OF BANKING**

This Banking Act was enacted to address deposits protection after a crisis and the intention is to protect and control the banking industry.

There are other relevant statutes to the banking industry and financial services i.e. the Central Bank of Kenya Act, the Building Societies Act, the Companies Act to a certain extent etc. The current Banking Act Cap 488 came into force in November of 1989. In enacting this statute parliament was seeking to address a crisis in the industry that was precipitated by the collapse of a number of institutions. And under the provisions of this statute the previous Banking Act that essentially dealt with the relationship between the bank and the customer was repealed. Section 56 of the current Banking Act is a repealing provision repealing the previous statute. Running through the statute is the thread of the desire to protect depositors.

### **SOME OF THE PROBLEMS THAT WERE IDENTIFIED AS LEADING TO THE COLLAPSE OF THE FINANCIAL INSTITUTIONS OR BANKS INCLUDED:**

1. The perceived absence of stringent licensing requirements.
2. Inadequate supervision.
3. Control of the institutions by individual.
4. Under capitalisation.
5. Lack of proper management systems.
6. Lack of transparency in terms of operations.
7. Absence of adequate powers on the part of the regulator.
8. In terms of what central bank that remains the regulator could do etc.

### **LICENSING REQUIREMENTS**

The Banking Act under Section 3 prohibits any person from transacting any Banking Business or financial business or the business of a mortgage finance company unless

1. Such person is an institution;
2. Such institution is duly licensed or holds a valid licence.

An institution is defined under Section 2 of the Banking Act to mean a Bank or a Financial Institution or a Mortgage Finance Company. The provisions effectively therefore exclude an individual from conducting any of these classes of businesses.

### **RELATIONSHIP BETWEEN BANKER AND CUSTOMER**

The nature of relationship between a banker and customer depends upon the type of service rendered by the banker. The services rendered by commercial banks in our country can be classified into two categories.

- a. Traditional services
- b. New services

### **Traditional services**

- a. maintenance of different types of deposit accounts eg savings, fixed and current accounts.
- b. Grant to advances through cash credit, overdraft and loan accounts and through purchasing/discounting demand and usance bills.
- c. Collection of cheques, bills of exchange and other instruments (inland and foreign).
- d. Issue of performance and financial gurantees
- e. Provision of remittance facilities by issue of draft, mail transfers, and telegraphic transfers.
- f. Provision of facilities of safe deposit and safe custody.
- g. Purchase and sale of securities.

### **New services**

The banks have introduced a number of new services with the accent on deposit mobilization and grant of credit to weaker sections of society during recent years. Some of the important new services are as follows:

1. Schemes for deposit mobilization – a large number of new schemes have been introduced for deposit mobilization. Some of these schemes are as follows:
  - a. Certificate of deposit (CD) – is a document of title similar to a time deposit receipt issued by a bank. However there is no prescribed rate on such funds and the bank have the freedom to issue it at a discount or face value.it is a bearer document hence readily negotiable.
  - b. Daily saving schemes – small depositors are expected to deposit their money with the bank every day. Its especially meant for daily wage earners.
  - c. Minor savings scheme – this scheme has been introduced as an attempt to encourage children to form saving habit.
  - d. Ladies department – in order to attract women as depositors some banks have ladies departments.

- e. Monthly interest income schemes – they are fixed deposit accounts on which instead of annually or half yearly, monthly interest is either paid by way of cash or is credited to the current or savings deposit account of the depositor.
- f. Annuity retirement schemes – under this scheme monthly instalments of deposits are collected for a period of years. The amount is inclusive of interest.
- g. Farmers deposit schemes – is intended for the benefit of farmers who can save once or twice a year, when their income is received from harvest.
- h. Insurance linked savings bank account – provides life insurance protection on the life of an account holder covered under a special insurance linked bank account.
- i. Innovative deposit schemes – in order to attract deposits from the public many banks (particularly foreign banks) have started innovative deposit.
  - a. Multi deposit scheme – in case of a traditional fixed deposit scheme, if the depositor needs to withdraw even a small sum, he has to break the entire deposit. Alternatively he can take a loan or overdraft facility on his deposit.
  - b. Smart money scheme – this gives the depositor a smart alternative to his savings account. The depositor can withdraw upto 75% of his deposit whenever he wants it by just issuing a cheque.
  - c. Any time ATM Scheme – enables the depositor through ATM card to withdraw, deposit, check balances, transfer money and order for cheque book or statements, at a convenience, day or night, seven days a week.
2. **Housing deposit scheme** – these schemes are suitable for those wishing to acquire their own houses.
3. **Automatic extension deposit scheme** – depositors make a lump sum payment and deposits can be automatically renewed for any term as desired after the specified period.
4. Personal loan scheme – under the scheme individuals either employed or engaged in business and having a steady income, are granted loans to purchase durable goods eg household goods etc. these are clean loans and bank keep a lien on goods and reserve the right to seize them if borrower fails his part of the contract.
5. **Loan participation** – some of the larger borrowers are financed by more than one institution on a participation basis. This is done because the amount involved is very large and beyond the resources of a single institution.
6. **Schemes for financing industries** – banks provide term loans to small scale industrial units for expansion, modernization, renovation and also provide them with working capital. They also

grant loans to technocrats, technologists, technicians and entrepreneurs to set up small industrial units.

7. **Schemes for financing agriculture.**

8. **Financing road transport operators and small borrowers** – loans are granted for purchasing motor vehicles.

9. **Credit transfer systems** – as a result of increased customer expectations many banks have introduced schemes for free remittance of funds by their customers subject to certain conditions.

10. Credit cards

11. Travellers cheques – are issued by banks to avoid the risk of loss or inconvenience in having to carry large amount of cash while travelling.

12. Travel agency work – banks have started travel agency work for their clients such as securing of passage, accommodation in hotels, providing general travel information.

13. Gift cheques – the purchaser of a gift cheque need not be an account holder with that bank or any other bank to avail of that service. The cheque is collectable at par at all the offices of the issuing bank.

14. Lock-box and night safe service – is kept at the branch of the bank for customers to lodge cheques and other remittances after the bank's office hours.

15. Services after banking hours – a number of banks in Kenya have extended working hours.

16. Other services – tax assistance, executor and trustee, merchant banking etc since these services are highly specialized.

## **CUSTOMER**

The term customer has not yet been statutorily defined. In common parlance the term customer means a person who has an account with the bank. Old banking experts used to lay emphasis on the duration for which a person maintained an account with the bank. John Paget, (to constitute a customer there must be some recognizable course or habit of dealing in the nature of regular banking business....it is difficult to reconcile the idea of single transaction with that of a customer. Thus according to the view a person does not become a customer simply by opening an account with the bank. He should be in the habit of dealing with the bank. The above viewpoint, popularly known as **duration theory** has now been rejected. In the case

Commissioners of Taxation v. English, Scottish and Australian Bank Limited. (1920) A.C. 683

Their Lordships expressed themselves in the following language. Their Lordships are of the opinion that the word customer signifies a relationship in which duration is not of the essence. A person whose money

has been accepted by the bank on the footing that they undertake to honour cheques upto the amount standing to this credit is in the view of their Lordships a customer of the bank irrespective of whether his connection is of short or long standing. The contrast is not between an habitué and a new comer but between a person for whom the bank performs a casual service such as for instance cashing a cheque for a person introduced by one of their customers and a person who has an account of his own at the bank.

Effectively even if all a person has is one transaction, it does not disqualify the person from being a customer of the bank in the case of Landbroke v. Todd (1914) Vol 30 T.L.R.

Broadly speaking a customer is a person who has the habit of resorting to the same place or person to do business. Thus in order to constitute customer, a person should satisfy two conditions:

- a. He should have an account with the bank, whether fixed, savings or current.
- b. The dealings should be of a banking nature. These dealings have to be distinguished from other dealings which are of a casual nature. Eg occasionally getting a cheque encashed or purchasing stamps or depositing valuables for safe custody.

### **General relationship between a banker and customer**

The relationship between a banker and its customers can be put as follows:

1. **Debtor and creditor** – the respective position being determined by the existing state of account eg if the account is overdrawn the banker becomes the creditor. The money deposited with the banker becomes his property and is absolutely at his disposal whether he pays or does not pay interest on it. This is because the banker undertakes to repay on demand a sum equivalent to the amount deposited. The customer has no right to claim identical coins or notes deposited by him with the banker. However this relationship of debtor and creditor between a banker and its customers differs from similar relationship arising out of ordinary commercial debts, in the following respects:
  - a. Demand for repayment necessary – the general rule that demand for repayment by creditor is necessary and applicable in case of ordinary commercial debts, does not apply in case of banks. The customer must make an express demand for repayment to make the debt actually due for payment by the bank.
  - b. Demand should be made at a proper time and place – the demand for repayment should be made during normal working hours of the bank on a working day.
  - c. Demand must be made in proper manner – the demand for repayment of money should be made through a cheque or any other written order as per the common usage among the bankers.
2. **Trustee and beneficiary** – the banker acts as a trustee for his customers in those cases where he accepts securities and valuables for safe custody. In such cases customer continues to be the owner of

valuables or securities deposited with the bank and they are not available for distribution among the bank's creditors in the event of the bank going into liquidation.

3. **Principal and agent** – banker acts as the agent of the customer in those cases where it performs agency functions such as collection of cheques, bills of exchange purchasing and selling of securities, payment of insurance premium etc on behalf of customers.

4. **BANKER AS A BAILOR/BAILEE**

bailment, bailor, and bailee. A bailment is the delivery of goods by one person to another for some purpose upon a contract. As per the contract, the goods should when the purpose is accomplished, be returned or disposed off as per the directions of the person delivering the goods. The person delivering the goods is called the bailor and the person to whom the goods are delivered is called the bailee. Banks secure their loans and advances by obtaining tangible securities. In certain cases banks hold the physical possession of secured goods (pledge) – cash credit against inventories; valuables – gold jewels (gold loans); bonds and shares (loans against shares and financial instruments) In such loans and advances, the collateral securities are held by banks and the relationship between banks and customers are that of bailee (bank) and bailor.(borrowing customer).

5. **BANKER AS A LESSOR / LESSEE**

In case of safe deposit locker accounts, the banker and customer relationship of lessor/lessee is applicable. Banks lease the safe deposit lockers (bank's immovable property) to the clients on hire basis. Banks allow their locker account holders the right to enjoy (make use of ) the property for a specific period against payment of rent.

## **RIGHTS OF A CUSTOMER**

**The** consumer protection act has been enacted for providing better protection to consumers and settling of appropriate authorities for settlement of consumers disputes and other incidental matters. The term consumer includes a person who avails of any service for consideration. The term service includes a banking or financing service also.

A customer has right to approach with his complaint. The complaint may relate to any of the following matters.

- a. Any fault, imperfection shortcoming or inadequacy in the quality, quantity, nature and manner of performance which is required to be maintained by or under any law for the time being in force.
- b. Any unfair trade practice adopted by the banker. For example if the banker falsely represents that the services are of a particular quality standard or grade or makes a false or misleading representation concerning the need for or usefulness of any service.

If the court is satisfied that the allegations contained in the complaint about are true, it may ask the banker to do one or more of the following:

- a. To return to the customer the charge paid by the customer
- b. To pay such amount as may be awarded by it as compensation to the customer for any loss injury suffered by the customer due to the bankers negligence.
- c. To remove the defects or deficiencies in the service in question
- d. To discontinue the unfair trade practice or not to repeat it.
- e. To provide for adequate costs to the parties to the disputes.

### **OBLIGATIONS OF BANKER**

The primary relationship between a banker and his customer is that of a debtor and creditor. This relationship imposes the following special obligations on the banker.

**1. Obligation to Honour Cheques:** You know that a bank is the debtor of his customer. The bank has a statutory obligation to honour the cheques of its customers up to the amount standing to the credit of the customer's account. If a bank wrongfully refuses to honour the cheque of its customer, the bank shall be liable to compensate the customer. This obligation is subject to some conditions, namely:

- a) There must be sufficient funds of the customer in the hands of the bank.
- b) The funds must be properly applicable for the payment of the customer's cheque.
- c) The cheque must be properly drawn Up i.e., it should be complete in all respects.
- d) The cheque must be presented for payment within a reasonable time.
- e) There must be no legal bar preventing the payment of such cheques. If the bank has received any order from a court or any other competent authority prohibiting payment, it is the duty of the bank to obey such orders.

### **Garnishee order**

In case a debtor fails to pay the money due to his creditor, the latter may apply to the court to issue a garnishee order, on the debtors banker. As a result of this order the debtors account with the bank is frozen and the bank cannot make any payment out of the account. The creditors, on whose request such an order is issued is called the judgement creditor; the debtor whose account is frozen is called the judgement debtor and the banker who has the customers account is called the garnishee.

The garnishee order is issued by the court in two parts:

- (i) Order Nisi: by this order the court:
  - a. asks the banker to freeze the debtors account
  - b. asks the banker to explain why the funds in the account, so freezed should not be used for payment of judgement creditor.

On receipt of such an order the bank should immediately inform the customer so that he may make the necessary arrangements for payments of the debts due by him.

- (ii) Order absolute – this order directs the banker to pay either the whole or part of the funds lying in the account against which order NISI has been issued to the judgement creditor.

#### Illustration

A fails to pay his creditor B a sum of sh6000, B brings Garnishee order against the bank where A has an account having a balance of sh10000 prohibiting any payment out of this account. In spite of this the banker subsequently honours A's cheque for sh5000. The banker is liable for defying courts order and will have to compensate B for any loss that he may suffer on account of non-recovery of the full amount due to him.

#### **Different types of accounts and garnishee order**

- a. Joint account – a joint account is one which is opened in the names of two or more persons. Such account can be attached only when all the joint account holders are joint judgment debtors. However in case of a joint debt the individual accounts of the judgement debtors can be attached since their liability for a joint as well as several.

#### Illustrations

A owes a sum of sh3000 to B, each one of them has a separate accounts with equity bank. The balance standing in the account cannot be attached for the above debt.

A and C jointly owe a sum of sh 3000 to B, each one of the has separates accounts with equity. Their individual accounts can be attached for the above debt.

- b. Partnership accounts – the personal account of a partner can be attached for payment of a firms debt. But the firm account cannot be attached for the payment of a personal loan of a partner.
- c. Trust accounts – the money lying in a trust account though opened in the trustees name cannot be attached for payment of personal liabilities of the trustees. The bank in such an eventuality should inform the court that the funds lying in the account are trust funds.

#### **Attachment order issued by income tax authorities**

Attachment order is issued by the Government authority say Income Tax, Sales Tax, Customs department for recovery of statutory dues from a person under the respective law which governs the concern department.

#### **Consequences of wrongful dishonor of cheques**

If the bank wrongly refuses to pay a customer's **cheque**, it breaches its contract with the customer and is liable for damages. If the customer suffers losses which are directly and foreseeably the result of the **dishonour**, these losses may be recovered from the bank. The most common damage is to the customer's credit.

### Illustration

R was a representative of a group of concerns at Nairobi. He issued a cheque on his personal account to pay off a telephone bill outstanding in the name of his principals. The cheque was wrongfully dishonoured by the bank. On account of non-payment, the telephone connection was disconnected by the telephone authorities. The principals got annoyed on disconnection of the telephone connection and they dismissed him. On a suit being filed by R, the Nairobi high court held that dismissal was attributable to the conduct of the bank. It awarded special damage to R to the extent of sh 14000 for the loss of prestige, status and mental agony for dishonor of a cheque for 294.40.

### Stop payment of cheques

A banker may receive instructions from the drawer or the holder of a cheque to stop payment of the cheque. The banker should take the following steps when such instructions are received.

- a. In case the instructions received from the drawer himself, the banker should immediately on receipt of instructions verify the signature of the drawer on the letter. If instructions are in order and the cheque has not already been paid, the particular of the cheque should be entered in stopped cheques register.
- b. The letter of acknowledgement of receipt of stop payment instructions should be issued to the customer.
- c. Proper instructions should be recorded conspicuously in the related account and stop payment.
- d. When a stopped payment cheque is presented the word stop should be written prominently in red ink across the cheque.
- e. Instructions to stop payment of a cheque received by telegram or telephone or from third party must be confirmed in writing by the drawer.

### Legal implications

The law recognises the customers right to give notice to bankers to stop payment of a cheque which he has issued. The notice should be in writing giving accurate particular of the cheque and should be signed by the drawer.

2. Obligation to Maintain Secrecy: The relationship between the banker and customer is of a nature. The bank must not disclose to any outsider the details concerning the customer's account; as such disclosures may adversely affect the credit and business of the customer. However, a disclosure can be made under the following two situations:

- a. When the law requires such disclosures to be made (legal necessity)

Disclosure under the income, disclosure under the companies act 1956, disclosure under of the court, disclosure under central bank act, disclosure under the banking regulation act, disclosure under foreign exchange act etc.

b. When the practices amongst the banks permit such disclosure (banking practice).

- **where customers consent has been obtained** – the customer may himself direct the banker to disclose the state of his account to his employee or messenger or any person acting as his agent.
- **Where bankers own interest require** – banker has to recover money from the customer, the banker can disclose the information regarding the customers account to its solicitor or lawyers.
- **Where credit information is required by other banks** – the banks exchange credit information about their customers. However the banker should observe the following precautions while furnishing such information:
  - ✓ The information should be based on the record of customers dealing with the banker
  - ✓ The banker should only give a general statement regarding his customers financial position without going into figures
  - ✓ The information should be given honestly.

c. **Where such disclosure is in public interest.**

- When a bank is asked for information by a government official concerning the commission of a crime and the bank has reasonable cause to believe.
- When bank considers that the customer is involved in activities prejudicial to the interests of the country.
- Where the banks books reveal that the customer is contravening the provisions of any law.
- Where sizeable funds are received from foreign countries by a constituent.

### **Consequences of wrongful disclosures**

**a. liability towards the third parties** – the banker will be liable to third parties for any loss that they might have suffered on account of wrong information supplied to them, such liability will arise only when:

- The banker intentionally furnishes wrong information
- The third party relies on such information and suffers loss.

**c. liability towards the customer** – banker is liable to compensate the customer for any material loss that he might have suffered on account of any wrongful disclosure or expression of extremely unfavourable opinion about him.

3. **Obligation to Follow Customer's Instructions:** The banker is under a legal obligation to follow the instructions of the customer. This is so because there is the contractual relationship between the bank and the customer.

4. **Obligation to Maintain Proper Records:** The banker is under an obligation to maintain accurate record of all the transactions of the customers made with the bank.

5. **Obligation to give Notice before Closing the Account:** If a bank wishes to close the account of a customer, it must give a reasonable notice to this effect to the customer. Thus, a bank cannot close the account of a customer on its own, because it may have serious consequences to the customer.

### ***Rights of a Bank***

For fulfilling the obligations towards the customers, bankers enjoy the following rights:

**1. Right of General Lien:** One of the most important rights enjoyed by a bank is the right of general lien. Lien is a right of a person to retain goods belonging to another; until the demands of the person in possession are satisfied. Section 171 of the Indian Contract Act confers the right of general lien on the bankers. General lien entitles the banker in possession to retain goods and securities till all its claims against the customer are satisfied. You should note that the banker can exercise his right of general lien only as a banker and not as a bailee, Banker's lien is an implied pledge in the sense that if a default is made by the debtor, the banker can, after giving a reasonable notice to the customer, sell the goods in his possession and recover the amount. If some valuables are deposited with a bank for safe custody, then it is

bailment and the bank cannot exercise the right of general lien. You should note that the right of general lien cannot be exercised in the following cases:

- a) When valuables are deposited for safe custody,
- b) When money or documents are deposited for a specific purpose,
- c) When some securities are left with the bank by mistake,
- d) When the property is held by the customer as trustee and the bank has the notice of trust, and
- e) When there is an express agreement that the bank shall not exercise the right of general lien.

**2. The Right of Set-off:** Right of set-off is the right of a debtor to adjust the amount due to him from a creditor against the amount payable by him to the creditor to determine the net balance payable by one to another. Like any other debtor, a bank also has a right of set-off. When a customer has two or more accounts in the same name and capacity in a bank, the bank has the right to adjust the amount standing to the credit of the customer against the debit balance in the other account. The bank has a right to combine the two accounts. For example, Mr X has overdrawn his current account to the extent of Rs. 10,000 and he has a credit balance of Rs.8,000 in his savings account. The bank can combine these two accounts and claim the balance of Rs.2,000 after adjusting the credit balance of savings account against the debit balance of current account,

**3. Right of Appropriation:** A customer may owe several distinct debts to the bank. When the customer deposits some money in the bank without specific instructions and the amount is not sufficient to discharge all debts, then the problem arises as towards which debt this amount should be adjusted. In the absence of any specific instructions, the bank has the right to appropriate the deposited amount to any loan, even to a time barred debt. But the banker must inform the customer about the appropriation.

**4. Right to Charge Interest and Commission:** The bank has the implied right to charge interest on loans and advances, and also to charge commission for services rendered by the bank. The bank can debit such charges to the customer's account.

**5. Right to Close the Account:** If the bank is of the opinion that an account is not being operated properly, it may close the account by sending a written intimation to the customer.

## **VARIOUS TYPES OF CUSTOMERS**

Accounts of individuals form a major chunk of the deposit accounts in the personal segment of most banks. Individuals who are major and of sound mind can open a bank account.

### ***(a) Minors:***

In case of minor, a banker would open a joint account with the natural guardian. However to encourage the habit of savings, banks open minor accounts in the name of a minor and allows single operations by the minor himself/herself.

### ***(b) Joint Account Holders:***

A joint account is an account by two or more persons. At the time of opening the account all the persons should sign the account opening documents. Operating instructions may vary, depending upon the total number of account holders.

### ***(c) Illiterate Persons***

Illiterate persons who cannot sign are allowed to open only a savings account (without cheque facility) or fixed deposit account. They are generally not permitted to open a current account. The following additional requirements need to be met while opening accounts for such persons:

- The depositor's thumb impression (in lieu of signature) is obtained on the account opening form in the presence of preferably two persons who are known to the bank and who have to certify that they know the depositor.
- The depositor's photograph is affixed to the ledger account and also to the savings passbook for identification.

Withdrawals can be made from the account when the passbook is furnished, the thumb impression is verified and a proper identification of the account holder is obtained.

### ***(d) Firms***

The concept of 'Firm' indicates either a sole proprietary firm or a partnership firm. A sole proprietary firm is wholly owned by a single person, whereas a partnership firm has two or more partners. The sole-proprietary firm's account can be opened in the owner's name or in the firm's name.

### ***(e) Companies***

A company is a legal entity, distinct from its shareholders or managers, as it can sue and be sued in its own name. It is a perpetual entity until dissolved. Its operations are governed by the provisions of the Companies Act, 1956. A company can be of three types:

- Private Limited company: Having 2 to 51 shareholders.
- Public company: Having 7 or more shareholders.
- Government company: Having at least 51 per cent shareholdings of Government (Central or State).

The following requirements are to be met while opening an account in the name of a company:

- The account opening form meant for company accounts should be filled and specimen signatures of the authorized directors of the company should be obtained.
- Certified up-to-date copies of the Memorandum and Articles of Association should be obtained. The powers of the directors need to be perused and recorded to guard against '*ultra vires*' acts of the company and of the directors in future.
- Certificate of Incorporation (in original) should be perused and its copy retained on record.
- In the case of Public company, certificate of commencement of business should be obtained and a copy of the same should be recorded. A list of directors duly signed by the Chairman should also be obtained.
- Certified copy of the resolution of the Board of Directors of the company regarding the opening, execution of the documents and conduct of the account should be obtained and recorded.

#### **(f) Trusts**

A trust is a relationship where a person (trustee) holds property for the benefit of another person (beneficiary) or some object in such a way that the real benefit of the property accrues to the beneficiary or serves the object of the trust. A banker should exercise extreme care while conducting the trust accounts, to avoid committing breach of trust:

- A trustee cannot delegate his powers to other trustees, nor can all trustees by common consent delegate their powers to outsiders.
- The funds in the name of the trust cannot be used for crediting in the trustee's account, nor for liquidating the debts standing in the name of the trustee.
- The trustee cannot raise loan without the permission of the court, unless permitted by the trust deed.

#### **(g) Clubs**

Account of a proprietary club can be opened like an individual account. However, clubs that are collectively owned by several members and are not registered are treated like an unregistered firm. While opening and conducting the account of such clubs, the following requirements are to be met:

- Certified copy of the rules of the club is to be submitted.
- Resolution of the managing committee or general body, appointing the bank as their banker and specifying the mode of operation of the account has to be submitted,
- The person operating the club account should not credit the cheques drawn favouring the club, to his personal account.

#### **(h) Local Authorities**

Bankers should ensure that accounts of such bodies are opened and conducted strictly as per the provisions of the relevant Act and regulations framed there under. The precautions applicable for company or trust accounts are also applicable in the case of these accounts, in order to guard against *ultra vires* acts by the officers of the local authority operating the account.

**(i) Co-operative societies**

Co-operative societies are required to open accounts only with these banks which are recognized for this purpose (under the Co-operative Society Act). The following documents should be obtained while opening their account:

- Certificate of registration of the society under the Co-operative Society Act.
- Certified copy of the bye-laws of the society.
- Resolution of the managing committee of the society prescribing the conditions for the conduct of the account.
- List of the members of the managing committee with the copy of the resolution electing them as the committee members.

**CLOSING OF A BANK ACCOUNT - TERMINATION OF BANKER-CUSTOMER RELATIONSHIP**

Banker-customer relationship is a contractual relationship between two parties and it may be terminated by either party on voluntary basis or involuntarily by the process of law. These two modes of termination are described below.

**1. Voluntary Termination:** The customer has a right to close his demand deposit account because of change of residence or dissatisfaction with the service of the banker or for any other reason, and the banker is bound to comply with this request. The banker also may decide to close an account, due to an unsatisfactory conduct of the account or because it finds the customer undesirable for certain reasons. However, a banker can close an account only after giving a reasonable notice to the customer. However, such cases of closure of an account at the instance of the banker are quite rare, since the cost of securing and opening a new account is much higher than the cost of closing an account. If a customer directs the banker in writing to close his account, the banker is bound to comply with such direction. The latter need not ask the reasons for the former's direction. The account must be closed with immediate effect and the customer be required to return the unused cheques.

**2. If the Bank desires to close the account:** If an account remains un-operated for a very long period, the banker may request the customer to withdraw the money. Such step is taken on the presumptions that the customer no longer needs the account. If the customer could not be traced after reasonable effort, the banker usually transfers the balance to an "Unclaimed Deposit Account", and the account is closed. The balance is paid to the customers as and when he is traced. The banker is also competent to terminate his relationship with the customer, if he finds that the latter is no more a desirable customer. The banker takes this extreme step in circumstances when the customer is guilty of conducting his account in an unsatisfactory manner, *i.e.* if the customer is convicted for forging cheques or bills or if he issues cheques

without sufficient funds or does not fulfil his commitment to pay back the loans or overdrafts, etc. The banker should take the following steps for closing such an account.

(a) The banker should give to the customer due notice of his intention to close the account and request him to withdraw the balance standing to his credit. This notice should give sufficient time to the customer to make alternative arrangements. The banker should not, on his own, close the account without such notice or transfer the same to any other branch.

(b) If the customer does not close the account on receipt of the aforesaid notice, the banker should give another notice intimating the exact date by which the account be closed otherwise the banker himself will close the account. During this notice period the banker can safely refuse to accept further credits from the customer and can also refuse to issue fresh cheque book to him. Such steps will not make him liable to the customer and will be in consonance with the intention of the notice to close account by a specified date.

**3. Termination by Law:** The relationship of a banker-customer can also be terminated by the process of law and by the occurrence of the following events:

(a) **Death of customer:** On receiving notice or information of the death of a customer, the bank stops all debit transactions in the account. However, credits to the account can be permitted. The balance in the account is given to the legal representative of the deceased after obtaining the letters of administration, or succession certificate, or indemnity bond as per the prescribed procedure, and only then, the account is closed.

(b) **Bankruptcy of customer:** An individual customer may be declared bankrupt, or a company may be wound up under the provisions of law. In such an event, no drawings would be permitted in the account of the individual/company. The balance is given to the Receiver or Liquidator or the Official Assignee and the account is closed thereafter.

(c) **Garnishee Order:** After receiving a garnishee order from a court or attachment order from income tax authority, the account can be closed as one of the options after taking the required steps.

(d) **Insanity of the customer:** A lunatic/person of unsound mind is not competent to contract. Since banker-customer relationship is contractual, the bank will not honour cheques and can close the account after receiving notice about the insanity of the customer and receiving a confirmation about it through medical reports.

## COMMERCIAL BANKS

**Meaning:** A Banking company is one which transacts the business of banking which means the accepting for the purpose of lending all investments, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise. The banking can therefore be conceived as a 'a sector of economy on the one hand and as a lubricant for the whole economy on the other'.

## FUNCTIONS

The functions of the commercial banks are now wide and diverse. They have assumed great significance in the role of an agent for economic renaissance and social transformation because of their vital role in mobilization of resources well as their deployment for meeting the said objectives. They are no longer considered as institutions only for affluent sections of the population. They have acquired broad base and have emerged as effective catalytic agents of social economic change. In order to understand better the functions of commercial banks, it will be better to study them under the following two categories.

(I) Primary Functions of commercial Banks.

(II) Secondary Functions of commercial Banks.

### Primary Functions of Commercial Banks

The primary functions of commercial banks are: (i) Accepting of deposits, and (ii) Lending of money.

**Accepting of Deposits:** Deposits are an important source of a banks funds. They can broadly be classified into three categories.

(a) **Savings Deposits:** These deposits are of small amounts and are accepted by banks to encourage persons of small means to make savings; frequent withdrawals are not allowed.

(b) **Fixed Deposits:** These deposits are made with the banks for fixed periods specified in advance. They are also known as term deposits.

(c) **Current Deposits:** These deposits are repayable on demand. The banks undertake the obligation of paying all cheques drawn against these deposits by the customers till they have adequate funds of the customer. The banks usually do not pay any interest in respect of such deposits. These deposits accounts are usually kept by large business houses.

**Lending of Money:** A major portion of the deposits received by a bank is lent by it. This is also the major source of a bank's income. However, lending money is not without risk and, therefore, a banker must take proper precautions in this process. The lending may be in any of the following forms:

(a) **Loan:** It is a kind of advance made with or without security. It is given for a fixed period at an agreed rate of interest. The amount of loan is usually credited to the credit of the customer's account who may withdraw from there as per his requirements. The loan may be secured or unsecured.

(b) **Cash Credit:** It is an arrangement by which a banker allows his customer to borrow money upto a certain limit against security of goods.

(c) **Overdraft:** It is an arrangement whereby a customer has been allowed temporarily to overdraw his current account. It is without any security.

(d) **Discounting and Purchasing of Bills:** Time bills are discounted while demand bills are purchased by the banks. In both the cases the banks credit the account of their customers by the

amount of bills less any discount or commission charged for such discounting or purchasing of the bills. Thus, commercial banks render a unique service by tapping savings from a wide spectrum of people and lending to those who really need and use them for various productive purposes. They play an active and not a passive role in the economic development of the country.

### **Secondary Functions of Commercial Banks**

These functions can be classified into the following two categories:

**(a) Agency Service:** In many cases the commercial banks act as the agents of their customers.

As agents they provide the following services:

- (i) Collection of drafts, bills, cheques, dividend etc. on behalf of customers.
- (ii) Execution of standing orders of the customers, payment of subscription, rent, bills, promissory notes, insurance premium etc.
- (iii) Conducting stock exchange transactions i.e., purchasing and selling of securities for the customers.
- (iv) Acting as a correspondent on representative of customers, other banks and financial corporations.
- (v) Functioning as an executor, trustee or administrator of an estate of a customer.
- (vi) Preparation of income tax return, claiming of tax refunds and checking of assessments on behalf of the customers.

**(b) General Utility Services:** Commercial banks provide a variety of general utility services. issue of letters of credit, travelers cheques, accept valuables for safe custody, acting as a referee as to the respectability and financial standing of the customers, providing specialized advisory services to customer, issue of credit cards, providing of information through regular bulletins about general trade and economic conditions both inside and outside the country etc.

## **LAW RELATING TO NEGOTIABLE INSTRUMENTS**

The term negotiable instrument literally means a written document which creates a right in favor of some person and which is freely transferable. Also a negotiable instrument means a promissory note, bill of exchange or cheque, payable either to order or to bearer whether the words 'order' or 'bearer' appear on the instrument or not.

### **Essential characteristics of a negotiable instrument**

#### **1. Property**

The possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument does not merely give possession of the instrument but right to property also. The property in a negotiable instrument can be transferred without any formality. In the case of a bearer

instrument, the property passed by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transfer of property.

## **2. Title**

The transferee of a negotiable instrument is known as holder in due course.' A bonafide transferee for value is not affected by any defect of title on the part of the transferor or of any of the previous holders of the instrument. This is the main distinction between a negotiable instrument and other subjects of ordinary transfer. The general rule of *nemo dat quod non habet* does not apply to negotiable instruments.

## **3. Rights**

The transferee of the negotiable instrument can sue in his own name, in case of dishonor.

A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

## **4. Presumptions**

Certain presumptions apply to all negotiable instruments e.g. a presumption that consideration has been paid under it.

## **5. Prompt Payment**

A negotiable instrument enables the holder to expect prompt payment because a dishonor means the ruin of the credit of all persons who are parties to the instrument.

### **Examples of negotiable instruments**

(a) Negotiable instruments recognized by statute :

i) Bills of exchange

ii) Promissory notes.

iii) Cheques.

### **PROMISSORY NOTES**

It is a written negotiable instrument duly signed by the maker that contains an unconditional promise to pay the stated sum of money to a particular person or to any other person, on the order of that particular person, either on demand or on a specified date, under given terms. It is a short-term credit instrument which does not amount to a bank note or a currency note.

### **Characteristics of Promissory Note**

- It is a written document.
- There must be a clear and unconditional promise to pay a certain sum to a specified person or on demand.
- It must be drawn and duly signed by the maker.
- It must be properly stamped.
- It specifies the name of the maker and payee
- The amount to be paid must be certain, given in both figures and words.
- Payment is to be made in the country's legal currency.

### **BILLS OF EXCHANGE**

Bill of Exchange, can be understood as a written negotiable instrument, that carries an unconditional order to pay a specified sum of money to a designated person or the holder of the instrument, as directed in the instrument by the maker. The bill of exchange is either payable on demand, or after a specified term.

In a business transaction, when the goods are sold on credit to the buyer, the seller can make the bill and send it to the buyer for acceptance, which contains the details such as name and address of the seller and buyer, amount of bill, maturity date, signature, and so forth.

### **Features of Bill of Exchange**

- An instrument which a creditor draws upon his debtor.
- It carries an absolute order to pay a specified sum.
- The sum is payable to the person whose name is mentioned in the bill or to any other person, or the order of the drawer, or to the bearer of the instrument.
- It requires to be stamped, duly signed by the maker and accepted by the drawee.
- It contains the date by which the sum should be paid to the creditor.

## CHEQUE

A Cheque generally is an order by the customer of a bank directing the bank to pay on demand, the specified amount to the bearer of the cheque or for the person which the cheque is issued. A Cheque is a usual method of withdrawing money from a current account of the customer with the bank. Savings accounts are also permitted to use cheque by maintaining a certain amount of balance in the account.

## PARTIES OF CHEQUE

- Drawer – the drawer is the person who writes or issues the check
- Payee – the payee is the person to whom the order the check is made out
- Drawee – the drawee is the bank which the drawer has a bank account with. It pays from the balance in customer bank account.

## TYPES OF CHEQUE

The Cheques are of various types and most common of them are

**1. ELECTRONIC CHEQUE** – The electronic image form of the cheque is called as ‘Electronic Cheque’. It is written and signed in a secure system using a digital signature.

**2. TRUNCATED CHEQUE** – The cheque which is the paper form is called as ‘Truncated cheque’. It has a physical structure and can be moved from one person to other by hand.

Every bank has its own cheque forms printed and is given to the customers after the opening of the account with the bank. These Cheque forms are printed on special security papers to protect the customers from fraud.

Basis Comparison	for Cheque	Bill of Exchange
Meaning	A document used to make easy payments on demand and can be transferred through hand delivery is known as cheque.	A written document that shows the indebtedness of the debtor towards the creditor.
Defined in	Section 6 of The Negotiable Instrument Act, 1881	Section 5 of The Negotiable Instrument Act, 1881

<b>Basis for Comparison</b>	<b>Cheque</b>	<b>Bill of Exchange</b>
Validity Period	3 months	Not Applicable
Payable to bearer on demand	Always	Cannot be made payable on demand as per RBI Act, 1934
Grace Days	Not Applicable, as it is always payable at the time of presentment.	3 days of grace are allowed.
Acceptance	A cheque does not require acceptance.	Bill of exchange needs to be accepted.
Stamping	No such requirement.	Must be stamped.
Crossing	Yes	No
Drawee	Bank	Person or Bank
Noting Protesting	or If the cheque is dishonoured it cannot be noted or protested	If a bill of exchange is dishonoured it can be noted or protested.

## **LEGAL ASPECTS OF BANKING OPERATIONS/SERVICES**

Banks maintain operating accounts like Savings Bank, Current, Overdraft and Cash Credit accounts which are operated by the cheques drawn by the account holders on their bankers. While handling these cheques, a banker may act as a paying banker (when cheques are drawn on him) or collecting banker (when cheques are deposited with him). Banks are under statutory obligation to honour a cheque and make payment if it is in order as per relevant laws.

## **LEGAL ASPECTS OF A CHEQUE**

### **Definition of a Cheque**

A cheque is defined as:-

- (i) A cheque is a bill of exchange drawn on a specified banker
- (ii) Payable on demand
- (iii) Drawn on a specified banker
- (iv) Electronic image of a truncated cheque (CTS) is recognized under law. This recognizes (a) digital signatures and (b) electronic transfer as well.

A cheque is nothing but a bill of exchange with special features (i) It is always payable on demand ( A bill of exchange can be payable on demand/at sight and/or after a specific term called as usance bill) (ii) always drawn on a specified banker i.e., the drawee of a cheque is the banker on whom the cheque is

drawn. The banker with whom the customer holds his/her account. This drawee bank is called the paying bank.

**The parties to a cheque are:**

Drawer: customer who draws the cheque on his account. Drawee – the banker on whom the cheque is banker and payee – the beneficiary of the cheque in whose payable.

Apart from the above three parties, others involved in payment and collection of cheques are :

*Endorser:* The person who transfers his right to another person

*Endorsee:* The person to whom the right is transferred

**Different types of cheques**

**(1) Open Cheque:**

A cheque is classified as 'Open' when cash payment is allowed across the counter of the bank.

**(2) Bearer Cheque:**

A cheque which is payable to any person who holds and presents it for payment at the bank counter is called a 'Bearer cheque'. A bearer cheque can be transferred by mere delivery without any endorsement.

**(3) Order Cheque:**

An order cheque is a cheque which is payable to a particular person. In case of order cheque, the word 'bearer' might have been cancelled and the word 'order' is written. The payee can transfer an order cheque by endorsement to another person by signing his name on the back of the cheque

**CROSSING OF A CHEQUE**

A cheque may be classified:

- a. An open cheque which can be presented for payment by the holder at the counter of the drawees bank.
- b. A crossed cheque which can be paid only through a collecting banker.

**Crossing defined**

A cheque is said to be crossed when two parallel lines with or without any words are drawn across its face. A crossing is a direction to the paying banker to pay the money generally to a banker or a particular banker as the case may be, and not to the holder at the counter. Crossing may be written, stamped, printed or perforated.

**Object of crossing**

Crossing affords security and protection to the true owner, since payment of such a cheque has to be made through a banker. It can therefore be easily detected to whose use the money has been received. Cheques are crossed in order to avoid losses arising from open cheques falling into the hands of wrong persons.

Crossing of a cheque does not affect its negotiability. Crossed cheques are negotiable by delivery in case they are payable to bearer and by endorsement and delivery where they are payable to order. Holder of a crossed cheque who has no account in any bank, can obtain payment by endorsing it in favor of some person who has got an account in a bank.

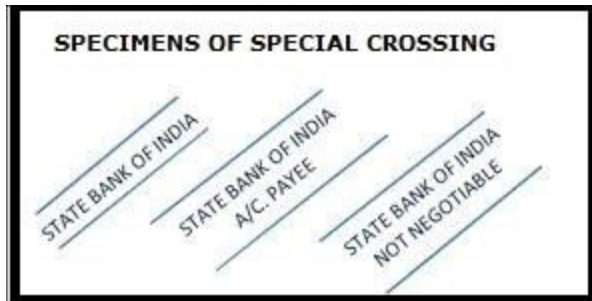
### Modes of crossing

Crossing may be general, special or restrictive.

1. **General crossing** – where a cheque bears across its face two transverse parallel lines with or without any words, it is called general crossing. Words such as ‘company of the crossing. In or any other abbreviations e.g & Co. may be written in between these two transverse lines, either with or without words ‘not negotiable’. Absence of these words would not affect validity of the crossing. In this case the banker upon whom the cheque is drawn will make the payment only to some other banker.



2. **Special crossing** – where a cheque bears across its face an addition of the name of a banker with or without the words not negotiable it shall be deemed special crossing. When a cheque has been specially crossed, the banker upon whom it has been drawn will make the payment only to that banker in whose favour it has been crossed.



3. **Restrictive crossing** – besides the above two types of statutory crossing, in recent years the practice of crossing cheques with the words account payee or account payee only has sprung up. Such a crossing is termed as restrictive crossing. It is only a direction to the collecting banker that the proceeds are to be credited only to the account of payee named in the cheque. In case the collecting banker allows the proceeds to be credited to some other account, it may be held liable for wrongful conversion of funds.



### Who can cross a cheque

1. The drawer – the drawer can make general, special or restrictive crossing on a cheque before issuing it.
2. The holder i.e (a) where a cheque is uncrossed, the holder may cross it generally or specially. (b) where a cheque is crossed generally the holder may cross it specially. (c) where a cheque is crossed generally or specially the holder may add the words negotiable.
3. The banker - Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker to work as its agent for collection. It is to be noted that a cheque can be specially crossed only once except where the second crossing is to a banker as the agent for collection.

Example

A draws a bill of exchange payable to B only. The bill is accepted by C. the bill bears the words 'not negotiable'. B endorses the bill to E. the bill is dishonoured on maturity. E sues C thereon. Will he succeed.?

E will not succeed since the words 'not negotiable' made the instrument non-transferable. B could not endorse the bill to E. E acquired no title to the bill. The bill was valid between the parties A and B.

### **Double crossing**

When a cheque bears two separate special crossings, it is said to have been doubly crossed. Where a cheque is crossed specially to more than one banker except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereon. Thus a paying banker shall pay a cheque doubly crossed only when the second banker is acting only as the agent of the first collecting banker and this has been made clear on the instrument.

### **Obliterating a crossing**

A cheque whose crossing is obliterated or erased by dishonest persons. In case of such cheques the paying bank shall be discharged from liability:

1. The cheque is not apparent at the time of its presentation for payment, and
2. The payment has been made in due course.

### **Opening crossing**

Cancellation of crossing of a cheque is called opening of crossing. The cancellation can be done only by the drawer of the cheque. The drawer after cancellation of crossing will put his signature and write 'pay cash' on the cheque.

### **Liability of the paying banker on crossed cheque**

The paying banker should make payment of a crossed cheque only through the collecting banker. In case of special crossing the payment of cheque should be done only to the banker whose name has been mentioned between the two transverse parallel lines. In case the paying banker makes payment of a crossed cheque in contravention of the above rules, its liability will be as follows:

1. The paying banker will have to reimburse the true owner for any loss that he might have suffered on account of payment being made to a wrong person.
2. The paying banker shall not be entitled to debit his customers account with the amount of payment in case payment has been made to a wrong person since it has not followed the mandate of the customer. Such payment will not be taken as a payment made in due course.

### **Marking of cheque**

a marked cheque means a cheque which is marked or certified by drawee banker to the effect that it is good for payment. Drawee bank thus intimates that it had sufficient funds to the credit of the drawer at the time when it certified the cheque and the cheque was apparently alright in all other respects.

Marking of a cheque by the drawee bank is generally done by writing the words good for payment across one corner of the cheque, with the banks stamp and initials of banks authorized official. It may be done at the request of (a) the drawer, (b) the holder and (c) the collecting banker.

- a. Marking by the request of drawer – when a cheque is marked by the drawee bank at the request of the drawer the letter cannot stop payment. In case he does so, he shall be liable to indemnify the banker for any loss, the banker may be required to pay because of refusing to make payment to a subsequent holder of the cheque who took it on the faith of such marking.
- b. Request at the request of the holder – when the holder gets the cheque marked by the drawee banker, it does not amount to the acceptance of the liability on the cheque by bank. It simply indicates that drawee banker has sufficient funds to the credit of the drawer to meet the cheque at the time of marking it.
- c. Marking at the request of collecting banker – when a cheque is received by a collecting banker too late for inclusion in the days clearing it may get it marked from the paying banker to protect the customer from any loss that he may suffer on account of delay in presentation.

#### Example

A cheque drawn on Equity bank on 13<sup>th</sup> june post dated to 20<sup>th</sup> june was certified by the manager of the bank, ‘good for payment on 20<sup>th</sup> june’. Kcb became holder in due course of the cheque, which when presented for payment on 20<sup>th</sup> june, was dishonored on account of funds being insufficient. It was held that the Equity bank was not liable on the cheque.

The above decision makes it clear that marking of a cheque only certifies the existence of sufficient balance of money to the credit of the drawer on particular date.

## NEGOTIATIONS and ASSIGNMENT OF NEGOTIABLE INSTRUMENT

Basis Comparison	for Negotiation	Assignment
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Basis for Comparison	Negotiation	Assignment
Meaning	Negotiation refers to the transfer of the negotiable instrument, by a person to another to make that person the holder of it.	Assignment implies the transfer of rights, by a person to another, for the purpose of receiving the debt payment.
Governing Act	Negotiable Instrument Act, 1881	Transfer of Property Act, 1882
Effected by	Mere delivery in case of bearer instrument and, endorsement and delivery in case of order instrument.	A written document duly signed by the transferor.
Consideration	It is presumed	It is proved
Title	Transferee gets the right of holder in due course.	Assignee's title is subject to the title of Assignor.
Transfer notice	Not required	Must be served by assignee on his debtor.
Right to sue	The transferee has the right to sue the third party, in his/her own name.	The assignee has no right to sue the third party in his/her own name.

### MODES OF NEGOTIATION

Negotiations may be affected by transferring a negotiable instrument with or without endorsement to another person. Instruments payable to bearer can be transferred by mere delivery, while instruments payable to the order of a person are transfereable by delivery and endorsement. The two ways of negotiating the negotiable instrument, therefore are (1) delivery and (2) endorsement.

### DELIVERY OF NEGOTIABLE INSTRUMENT

Delivery is the voluntary transfer of the possession of the instrument. It should be given voluntarily and with the intention of transferring ownership of the instrument to whom it is delivered.

#### Example

A delivers a cheque to B for safe custody. This will not amount to negotiation because there is no intention to transfer the ownership of the instrument to B.

A owes B kes1000. A makes a promissory note for the amount payable to B. A dies and later on the promissory note is found in A's papers. A's legal representatives deliver the note to B. B has no right to sue on the note because there is no valid delivery.

#### Delivery of a negotiable instrument

1. Actual delivery – where the change of actual possession of the instrument takes place.

2. Constructive delivery – where the instrument is delivered to the servant, agent or any other person, who holds the instrument on behalf of the person to whom it was to be actually delivered.

Example

A endorses a promisory note in favor of B and holds it as B's agent. There is constructive delivery by A to B.

**Conditional delivery** where the instrument is delivered with some condition attached the negotiation is not valid, till the condition is fulfilled.

Example

A delivers a bearers cheque to B. there us a verbal agreement between A and B that B will encash the cheque or negotiate it further only when he supplies him with the goods. The property in cheque will pass to B only on supplying the goods.

## **ENDORSEMENT**

### **Definition of Endorsement**

Means writing of a persons name on the back of instrument for the purpose of negotiation.

“When the maker or the holder of a negotiable instrument signs the same otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, he is said to endorse the same and is called the endorser and the person to whom the instrument is endorsed is called the endorsee.”

### **Legal Provisions regarding Endorsements**

1. It must be on the instrument. The endorsement may be on the back or the face of the instrument and if no space is left on the instrument, it may be made on a separate paper attached to it called along.
2. It must be an endorsement of the entire bill. A partial endorsement that is which purports to transfer to the endorse a part only of the amount payable does not operate as a valid endorsement.
3. It must be made by the maker or holder of the instrument. A stranger cannot endorse it.
4. It may be made either by the endorser merely signing his name on the instrument or by any words showing an intention to endorse or transfer the instrument to a specified person.
5. It must be signed by the endorser. It is not necessary to write the full name initial may be sufficient. Thumb- impression should be attested.
6. It must be completed by delivery of the instrument. The delivery must be made by the endorser himself or by somebody on his behalf with the intention of passing property therein.

7. Endorsements in pencil or by a rubber stamp are usually not accepted.

8. in case a person signing a negotiable instrument only as an agent of another he should make this clear by adding the words for and on behalf of or per pro.

### **kinds of endorsements**

#### **Important kinds of endorsements are given below:**

##### **1. Blank or genera endorsementl:**

If the endorser signs his name only and does not specify the name of the endorsee, the endorsement is said to be in blank. The effect of a blank endorsement is to convert the order instrument into bearer instrument, which may be transferred merely by delivery.

##### **2. Endorsement in full or special endorsement:**

If the endorser, in addition to his signature, also adds a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person the endorsement is said to be in full.

If, for example, A, the holder of a bill of exchange, wants to make an endorsement in full to B, he would write thus: "Pay to B or order, SdA4." After such an endorsement it is only the endorsee, i.e., B, who is entitled to receive the payment of the instrument and to further negotiate the instrument by his endorsement.

A blank endorsement can easily be converted into an endorsement in full, the holder of a negotiable instrument endorsed in blank may, without signing his own name, by writing above the endorser's signature a direction to pay to any other person as endorsee, convert the endorsement in blank into an endorsement in full; and since such holder does not sign himself on the instrument he does not thereby incur the responsibility of an endorser.

##### **3. Partial Endorsement:**

A negotiable instrument cannot be endorsed for a part of the amount appearing to be due on the instrument. In other words, a partial endorsement which transfers the rights to receive only a part payment of the amount due on the instrument is invalid.

Such an endorsement has been declared invalid because it would subject the prior parties to plurality of actions (one action by holder for part value and another action by endorsee for part value) “and will thus cause inconvenience to them.

Moreover, it would also interfere with the free circulation of negotiable instruments. It may be noted that an endorsement which purports to transfer the instrument to two or more endorsees separately, and not jointly is also treated as partial endorsement and hence would be invalid.

Thus, where A holds a bill for ksh 2,000 and endorses it in favour of B for ksh 1,000 and in favour of C for the remaining ksh 1,000, the endorsement is partial and invalid.

where an instrument has been paid in part, a note to that effect may; be endorsed on the instrument and it may then be negotiated for the balance.

Thus, if in the above illustration the acceptor has already paid ksh 1,000 to A, the holder of the bill, A can then make an endorsement saying “Pay B or order” ksh 1,000 being the unpaid residue of the bill.” Such an endorsement would be valid.

#### **4. Restrictive endorsement:**

An endorsement which, by express words, prohibits the endorsee from further negotiating the instrument or restricts the endorsee to deal with his instrument as directed by the endorser is called ‘restrictive’ endorsement.

The endorsee under a restrictive endorsement gets all the rights of an endorser except the right of further negotiation. In other words, such an endorsement entitles the endorsee to receive the payment on due date and sue the parties for it but he cannot further negotiate the instrument.

#### **Illustrations:**

(a) B, the holder of the bill, makes an endorsement on the bill saying “Pay C only.” It is a restrictive endorsement as C cannot negotiate the bill further.<sup>2</sup>

(b) B, the holder of the bill, makes an indorsement on the bill, saying “Pay C for my use or “Pay C or order for the account of B.” In either case there is a restrictive endorsement as the right of further negotiation by C has been excluded thereby.

The person liable on the bill must pay by drawing a cheque in the name of the holder (or the endorser) B. If he makes the payment to C on C's own account, he will still be liable to B, the endorser; Hence C cannot endorse the bill further in his own name.

### **5. Conditional endorsement:**

If the endorser of a negotiable instrument, by express words in the endorsement, makes his liability, dependent on the happening of a specified event, although such event may never happen, such endorsement is called a 'conditional' endorsement.

The law permits a conditional endorsement and therefore it does not in any way affect the negotiability of the instrument. Thus, endorsements can validly be made in the following terms:

- (i) "Pay B or order on his marriage;"
- (ii) "Pay B on the arrival of Pearlless ship at Bombay."

In the case of a conditional endorsement the liability of the endorser would arise only upon the happening of the event specified. But the endorsee can sue other prior parties, e.g., the maker, acceptor, etc., if the instrument is not duly met at maturity, even though the specified event did not happen.

### **6. Sans recourse endorsement:**

When the endorser expressly excludes his own liability on the negotiable instrument to the endorsee or any subsequent holder in case of dishonour of the instrument, the endorsement is known as 'sans recourse' endorsement.

Such an endorsement is generally made by adding the words 'sans recourse' or 'without recourse.' Thus, "Pay X or order sans recourse" or "Pay X without recourse to me" or "Pay X or order at his own risk" is examples of this type of endorsement.

### **7. Facultative endorsement:**

When the endorser expressly gives up some of his rights under the negotiable instrument, the endorsement is called a 'facultative' endorsement. Thus, "Pay X or order, notice of dishonour waived" is a facultative endorsement.

As a result of such an endorsement the endorsee is relieved of his duty to give notice of dishonour to the endorser and the latter remains liable to the endorsee for the non-payment of the instrument, even though no notice of dishonour has been given to him.

### **General Rules regarding the Form of Endorsements**

An endorsement must be regular and valid in order to be effective. The appropriateness or otherwise of a particular form of endorsement depends upon the practice amongst the bankers. The following rules are usually followed in this regard.

1. *Signature of the endorser.* The signature on the document for the purpose of endorsement must be that of the endorser or any other person who is duly authorized to endorse on his behalf. If a cheque is payable to two persons, both of them should sign their names in their own handwriting. If the endorser signs in block letters, it will not be considered a regular endorsement.
2. *Spelling.* The endorser should spell his name in the same way as his name appears on the cheque or bill as its payee or endorsee.
3. *No addition or omission of initial of the name.* An initial name should neither be added nor omitted from the name of the payee or endorsee as given in the cheque. For example, a cheque is payable to S.C. Gupta should not be endorsed as S. Gupta or vice versa. Similarly, a cheque payable to Harish Saxena should not be endorsed as H. Saxena because it will be doubtful for the paying banker to ascertain that H. Saxena is Harish Saxena and nobody else. It is possible that some Hari Saxena has signed on the cheque as H. Saxena.
4. *Prefixes and suffixes to be excluded.* The prefixes and suffixes to the names of the payee or endorsee need not be included in the endorsement. For example, the words “Mr., Messrs, Mrs., Miss, Shri, Shrimati, Lala, Babu, General, Dr., Major, etc.” need not be given by the endorser otherwise the endorsement will not be regular. However, an endorser may indicate his title or rank, etc., after his signature. For example, a cheque payable to Major Raja Ram or Dr. Laxmi Chandra may be endorsed as ‘Raja Ram, Major’ or Laxmi Chandra, M.D.’ A cheque payable to Padmashri Vishnu Kant may be endorsed as Vishnu Kant, Padmashri.

### **LEGAL ASPECTS OF PAYING BANKER/LIABILITIES OF A BANKER**

The Negotiable Instruments Act, 1881 deals with negotiable instruments like promissory notes, bills of exchange, cheques and similar payment instruments such as demand drafts, dividend warrants, etc. A banker in his capacity as a banker deals with the above mentioned negotiable instruments on different occasions. The relationship between a banker and customer, being debtor-creditor relationship the banker

is bound to pay the cheques drawn by his customer. Thus a banker should be very cautious both at the time of honouring as well as dishouring his customers cheques.

**Precautions to be taken by a paying banker**

In order to protect its as well as the customers interests the paying banker should take the following precautions while making payment of his customers cheques.

1. Precaution regarding form of the cheque – the cheque should be in proper form.
2. Precaution regarding date – the banker should refuse to honour an undated cheque which has been presented to it for payment.  
  
Post-dated cheques i.e it bears a date which is yet to come, the banker should honour it only on or after the date mentioned.  
  
Stale cheque – or out dated cheque, it is the custom of the banker not to pay cheques presented after the period has elapsed.
3. Precaution regarding amount – banker should see that the amount mentioned both in figures and words are the same in the cheque.
4. Precautions regarding funds of the customer – there should be sufficient funds in the account of the customer for payment of the cheque.
5. Precautions regarding material alteration – in case a cheque is materially altered and banker makes the payment he shall be discharged from liability only when he proves the following:
  - The alteration could not be detected with reasonable care, prudence and scrutiny
  - The payment had been made in due course.
6. Precaution regarding drawers signature – a banker is expected to know the signatures of his customers.
7. Precaution regarding mutilated cheques – such a cheque should not be paid.
8. Precautions regarding banking hours – banker should make payment of only such cheques which have been presented to it for payments during banking hours.
9. Precautions regarding crossing – if the cheque is a crossed one, it should not be paid on the counter but through a collecting banker.

When may a banker refuse to honour a customers cheque

- When the balance to the credit of the customer is insufficient.
- When funds are not properly applicable to the payment of a cheque. Eg fixed accounts.
- After receiving the notice or information of death.
- When customer has informed the bank about the loss of cheque.
- When the bank comes to know the defect in the title of the person presenting cheque.
- When the bank receives notice of an assignment by customer of his credit balance.

- When customer closes the account before is presented.
- When cheque is post dated and is presented for payment before its ostensible date.

#### **Answers in case of dishonored cheque**

1. Refer to drawer (R.D) the bank puts such a note in those cases where the drawer does not have sufficient funds with the bank or when cheque has been tampered with.
2. Not sufficient, no effects or no funds (N.S, N.S, N.F)
3. Not arranged for (N.A) – used in a case where payment of cheque will result in an overdraft which has not been approved by the bank.
4. Effects not cleared E.N.C – Used in those cases where the drawer has given certain cheques, drafts etc for collection and the same have not been collected.
5. Endorsement irregular (E.I) – this phrase is used where endorsement is not in order.
6. Drawer deceased (D.D) –
7. Words and figures differ (W & F.D)

#### **LEGAL ASPECTS OF COLLECTION OF A CHEQUE**

Collection of cheques, bills of exchange and other instruments on behalf of a customer is an indispensable service rendered by a banker to his customer. When a customer of a banker receives a cheque drawn on any other banker he has two options before him – (i) either to receive its payment personally or through his agent at the drawee bank, or (ii) to send it to his banker for the purpose of collection from the drawee bank. In the latter case the banker, deputed to collect the amount of the cheque from another banker, is called the ‘collecting banker’. He presents the cheque for encashment to the drawee banker and on its realization credits the account of the customer with the amount so realized. A banker is under no legal obligation to collect his customer’s cheques but collection of cheques has now become an important function of a banker with the growth of banking habit and with wider use of crossed cheques, which are invariably to be collected through a banker only. While collecting his customer’s cheques, a banker acts either

- (i) as a holder for value, or
- (ii) as an agent of the customer.

The legal position of the collecting banker, therefore, depends upon the capacity in which he collects the cheques. If the collecting banker pays to the customer the amount of the cheque or credits such amount to his account and allows him to draw on it, before the amount of the cheque is actually realized from the drawee banker, the collecting banker is deemed to be its ‘holder for value’. He takes an undertaking from the customer to the effect that the latter will reimburse the former in case of dishonour of the cheque.

#### **Banker as a holder for value**

A banker becomes its holder for value by giving its value to the customer in any of the following ways:

- (a) by lending further on the strength of the cheque;
- (b) by paying over the amount of the cheque or part of it in cash or in account before it is cleared;
- (c) by agreeing either then or earlier, or as a course of business, that customer may draw before the cheque is cleared;
- (d) by accepting the cheque in avowed reduction of an existing overdraft; and
- (e) by giving cash over the counter for the cheque at the time it is paid in for collection.

In any of these circumstances the banker becomes the holder for value and also the holder in due course. He bears the liability and possesses the rights enjoyed by the holder for value. If the last but one endorsement is proved to be forged, he will be liable to the true owner of the cheque. But he shall have the right to recover the money from the last endorser, i.e., his own customer, if the customer is unable to pay, the banker himself will bear the loss. If the cheque sent for collections returned dishonoured, the collecting banker can sue all the previous parties after giving them notice of dishonour. It is, however, essential that the amount of the cheque is paid to the customer in good faith.

### **Collecting Banker as an Agent**

A collecting banker acts as an agent of the customer if he credits the latter's account with the amount of the cheque after the amount is actually realized from the drawee banker. Thereafter the customer is entitled to draw the amount of the cheque. The banker thus acts as an agent of the customer and charges from him a commission for collecting the amount from outstation banks. As an agent of his customer, the collecting banker does not possess title to the cheque better than that of the customer. If the customer has no title thereto, or his title is defective, the collecting banker cannot have good title to the cheque. In case the cheque collected by him did not belong to his customer, he will be held liable for conversion of money, i.e., illegally interfering with the rights of true owner of the cheque.

### **Conversion by the Collecting Banker**

Sometimes a banker is charged for having wrongfully converted cheques to which his customer had no title or had defective title. Conversion means wrongful or unlawful interference (i.e., using, selling, occupying or holding) with another person's property which is not consistent with the owner's right of possession. Negotiable instruments are included in the term 'property' and hence a banker may be charged for conversion if he collects cheques for a customer who has no title or defective title to the instrument. The basic principle is that rightful owner of the goods can recover the same from anyone who takes it without his authority and in whose hands it can be traced. When the banker acts as an agent of his customer for the collection of his cheques, he cannot escape this liability. However, the right of the true

owner is a restricted one and cannot be exercised in case the goods reach the hands of one who (i) receives it in good faith, (ii) for value, and (iii) without the knowledge that the other party had no authority thereon. Except these circumstances, the true owner of the goods (including the negotiable instrument) can file a suit for conversion.

### **Statutory Protection to Collecting Bank**

Non-liability of a banker receiving payment of cheque: A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment.

*Explanation:* A banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof.

For the collecting banker to claim the protection he has to comply with certain conditions and they are:

1. The collecting banker should have acted in good faith.
2. He should have acted without negligence.
3. He should receive payment for a customer.
4. The cheque should be crossed generally or specially to himself.

### **DUTIES OF THE COLLECTING BANK**

#### **Duty to open the account with references and sufficient documentary proof**

The duty to open an account only after the new account holder has been properly introduced to is *too* well grained into today's banker's mind that it would be impossible to find an account without introduction. The necessity to obtain introduction of a good customer is to keep off crooks and fraudsters who may open accounts to collect forged cheques or other instruments. As an added precaution RBI has insisted that while opening accounts photograph of the customer and sufficient documentary proofs for constitution and address be obtained.

In this regard the English Decision *Ladbroke vs Todd* (1914) 30 TLR 433 can be referred to. In this case a thief stole a cheque in transit and collected the same through a banker where he had opened an account without reference and by posing himself as the payee whose signature the thief forged. After the cheque was collected the thief withdrew the amount. The bank was held liable to make good the amount since it acted negligently while opening the account in as much as it had not obtained any reference.

#### **Duty to confirm the reference where the referee is not known or has given reference in absentia**

Though as a matter of practice bankers in India require introduction by an existing customer of the bank, this may not always be possible especially when the branch is newly opened. In such cases the customers

are required to get references from known persons in the locality or from the existing bankers. In such case the banker is required to make enquiries with the referee to confirm that the person whose account is newly opened is a genuine person.

In *Harding vs London Joint Stock Bank* [1914] 3 Legal Decision Affecting Bankers 81, an account was opened for a new customer after complying with the necessary formalities. The account was not opened by deposit of cash as is the usual practice but was by paying in a third party cheque. The bankers in the case made enquiries with the customer who thereupon produced a forged letter issued by his employer giving him power to deal with the cheque. It was thereafter found that the cheque was stolen by the customer and credited to his account. The bank was held negligent for failure to make necessary enquiries from the employer as to whether the customer who was an employee had in fact the necessary power to deal with the cheque.

#### **Duty to ensure crossing and special crossing**

It is the duty of the banker to ensure that the cheque is crossed specifically to himself and if the cheque is crossed to some other banker they should refuse to collect it. Similarly where the cheque is crossed to a specific account then crediting the same to another account without necessary enquiries would make him liable on the grounds of negligence. In case of “non-negotiable” crossing a banker cannot be held negligent merely because of collection of such instruments. In the case of *Crumpling vs London Joint Stock Bank Ltd.* [1911–13] All England Rep 647 it was held that a non-negotiable crossing is only one of the factors amongst others to be considered to decide about the bankers negligence and that the mere taking of a non-negotiable cheque cannot be held to be evidence of negligence on the part of the bankers.

#### **Duty to verify the instruments or any apparent defect in the instruments**

Sometimes the instrument which is presented for collection would convey to the banker a warning that a customer who has presented the instrument for collection is either committing a breach of trust or is misappropriating the money belonging to some other. In case the banker does not heed the warning which is required of a prudent banker then he could be held liable on the grounds of negligence as can be seen from the following cases:

(a) In *Underwood Ltd. vs Bank of Liverpool Martin Ltd.* [1924] 1 KB 775, the Managing Director of a company

paid into his private account large number of cheques which were to be paid into the company's account and the bank was held negligent since it did not make enquiries as to whether the Managing Director was in fact entitled to the amounts represented by these cheques.

#### **Duty to take into account the state of customer's account**

The collecting banker is required to take into account the status of the customer and also the various transactions that have taken place in the customer's account so as to know the circumstances and the

standard of living of the customer. If for example, a person is an employee and the nature of his employment is that of a clerk his salary would be known to the bank and any substantial credits by way of collection of cheques would be suspected and it would be the duty of the banker to take necessary precautions while collecting such cheques.

In *Nu-Stilo Footwear Ltd. vs Lloyds Bank Ltd.* [1956] 7 Legal Decisions Affecting Bankers P. 121, the plaintiffs who were manufacturer of ladies footwear were defrauded by their Secretary and Works Accountant who converted 9 cheques payable to the plaintiffs into his account. The Secretary opened the accounts in the defendant bank in a false name and as reference gave his real name. The bank thereupon called the reference and got a satisfactory reply which included the fact that the account holder had recently come down from Oxford and intended setting up a business of his own. The Secretary thereupon presented 9 cheques totally aggregating to £ 4855. Since these cheques were drawn on the plaintiffs they sued the defendant bank who had collected the cheques. The Court held that the collecting bank was negligent in as much as the collecting bank did not take necessary precautions because the amounts collected were inconsistent with the business of the account holder and therefore necessary enquires should have been made by the bank.

#### **Negligence of collecting bank in collecting cheques payable to third parties**

The collecting bank has to make necessary enquiries before any third party cheques are collected on behalf of its customer. In *Ross vs London County Westminster and Parrs Bank Ltd.* [1919] 1 KB 678, cheques payable to “the Officer in charge, Estate Office, Canadian Overseas Military Force” were used by an individual to pay off his debts. There was an instruction in all the cheques that it was negotiable by the concerned officer. However, it was held that the fact that the cheques were drawn in favour of the Officer in charge should have put the banker on enquiry and since no such enquiry was made by the banker the bank is liable on the grounds of negligence.

### **SPECIAL TYPE OF BANKERS CUSTOMER**

Every person who is competent to contract can open an account with a bank provided the bank is satisfied regarding his bonafides and is willing to enter into necessary business relations with him. But there are certain types of persons eg. Minors, lunatics, married woman etc. whose capacity to enter into valid contracts is subject to certain legal restrictions.

#### **MINORS**

A person who has not completed his 18<sup>th</sup> year of age is considered to be a minor. But in those cases where guardian to the person or property of the minor is appointed by the court or the property of the minor is put under the charge of a court of wards during the period of his minority, the person shall become major on completion of the age 21 years. Since an agreement made with a minor is absolutely void (except for necessities for which his property is liable), bank has to be extra cautious while entering into business relations with a minor. The following points should be kept in mind by the banker in this connection.

1. The banker may open a savings bank account – it will not be advisable to open a current account of a minor since in case of an overdraft the minor does not have any personal liability. The savings bank account may be opened in any of the following ways:
  - In the name of the minor himself.
  - In the joint names of the minor and his/her guardian.
  - In the name of guardian in the following way ABC natural guardian of X. (a) in case the account can be operated by the minor himself. The negotiable instruments Act provides that a minor may draw, endorse, deliver and negotiate a negotiable instrument. The account can be continued on minors attaining the age of majority. (b) in case the minor can operate the account only jointly with his or her guardian while in case (c) the account is to be operated by the guardian on behalf of the minor. In both cases on minors attaining majority the minor alone will be entitled to operate the account. His signatures may then be taken and balance be transferred to a new account in his name.
2. Recording the date of birth of a minor – the banker should record the date of birth of the minor as disclosed by his or her guardian at the time of opening the account.
3. Death of the minor guardian – in the event of death of a minor the money will be payable to his guardian. In case the guardian dies before the minor attains majority and the account is a joint account or to be operated by the guardian only, the money should be paid by the bank to the minor on attaining majority or to some person appointed by the court as his guardian.
4. Minor as a partner – a minor cannot be a partner in a firm but if all the partners agree he may be admitted to the extent of his share in partnership firm. His liability is limited only to the extent of his share in profits and property of partnership firm. He does not have any personal liability. However he shall be held liable as other ordinary partners unless he has exercised his option of disconnecting himself from the firm by a public notice within six months of his attaining majority.
5. Minor as an agent – a minor can be appointed as an agent. He can represent his principal in dealings with other parties. Thus the principal will also be liable to the banker for all his dealings

with the banker. The banker should obtain a written mandate from customer in case he wants that this account should be operated by an agent. The mandate should also specify the name of the person, his extent of authority together with specimen signatures.

### **Provisions regarding legal guardianship of a minor**

The guardian of a minor can be any of the following types:

- a. Natural guardian – the father of a minor boy or an unmarried girl is his or her natural guardian.
  - (1) On the death of the father of an infant, the mother, if surviving, shall, subject to the provisions of this Act, be guardian of the infant, either alone or jointly with any guardian appointed by the father; and when no guardian has been appointed by the father, or if the guardian appointed by the father is dead or refuses to act, the court may appoint a guardian to act jointly with the mother.
  - (2) On the death of the mother of an infant, the father, if surviving, shall, subject to the provisions of this Act, be guardian of the infant, either alone or jointly with any guardian appointed by the mother; and when no guardian has been appointed by the mother, or if the guardian appointed by the mother is dead or refuses to act, the court may appoint a guardian to act jointly with the father.
  - (3) Where an infant has no parent, no guardian of the person and no other person having parental rights with respect to it, the court, on the application of any person, may appoint the applicant to be the guardian of the infant.

- b. Testamentary guardian –

- (1) Either parent of an infant may by deed or will appoint any person to be guardian of the infant after his death.
- (2) A guardian so appointed shall act jointly with the surviving parent of the infant so long as that parent remains alive, unless that parent objects to his so acting.
- (3) If the surviving parent so objects, or if the guardian so appointed considers that the parent is unfit to have the custody of the infant, the guardian may apply to the court, and the court may either refuse to make any order in which case the parent shall remain sole guardian or take an order that the guardian so appointed shall act jointly with the parent or that he shall be sole guardian of the infant, and in the latter case may make such order regarding the custody of the infant and the right of access thereto of its parent as, having regard to the welfare of the infant, the court may think fit, and may further order that the parent shall pay to the guardian towards the

maintenance of the infant such weekly or other periodical sum as, having regard to the means of the parent, the court may consider reasonable.

(4) Where guardians are appointed by both parents, the guardians so appointed shall after the death of the surviving parent act jointly.

(5) If under section 3 a guardian has been appointed by the court to act jointly with the surviving parent, he shall continue to act as guardian after the death of that parent; but if the surviving parent has appointed a guardian, the guardian appointed by the court shall act jointly with the guardian appointed by that parent.

c. Guardian appointed by the court – the court may appoint a guardian for the minor. However the court is not authorized to appoint a guardian for a minor if, his father/husband is alive, unless the court is of the opinion that such father/husband is unfit to be guardian of the minor.

## **LUNATICS**

### **Lunatics, Drunkard or Intoxicated Person**

All contracts made by lunatics are void except those made during lucid intervals. A customer may become a lunatic after opening his account with the bank. In such a case the bank will not be responsible if it honours a cheque or bill duly drawn accepted or endorsed by the lunatic unless it is proved that it knew of his lunacy at the time of honoring or discounting. The bank should, therefore, suspend all operations on the account of a person who to its knowledge has become lunatic till it receives a proof of his sanity or gets an order of the court to that effect. A banker should treat a customer as sane till there is fairly conclusive evidence in support of his insanity.

The banker should take the following steps on receiving notice of customer's insanity.

1. It should return all cheques on customer's account with the words refer to drawer and not 'customer insane'.
2. It should make a careful note of the lunacy order as and when received from the court.
3. It should allow the operation of the account only as per the lunacy order.
4. It should not allow the customer to operate the account till he is certified by the court to be sane.

### **ACCOUNTS OF ILLITERATE PERSON**

An illiterate person may open an account with a bank. The banker should take the following steps:

**1) Thumb impression:** The left hand for man and right hand for woman thumb impression of the depositor should be obtained on the account opening form and the specimen signature sheet in the presence of an authorized supervising official.

**2) Identification mark:** Where possible, brief details of one or two identification marks of the depositor should be noted on the account opening form and the specimen signature sheet under authentication of an authorized official.

**3) Photograph:** Two copies of passport size of the depositor should be obtained and got renewed every three years.

4) General Implications and conditions for operation of the account should be explained to the depositor by an authorized official. Withdrawals from the account should generally be allowed only when the person comes personally and produces his or her passbook, balance confirmation certificate, and puts thumb impression on the cheque in the presence of bank officials.

## TRUSTEES

A trustee is a person in whom confidence is reposed. He is given control of an estate, usually of the deceased, for the benefit of certain person. The person reposing the trust is called the settlor. The person for whose benefit the trust is created is called the beneficiary. The document creating the trust is called the 'trust deed'.

A banker should take the following precautions while having business dealings with the trustees:

- (i) The banker should thoroughly study the trust deed. The trust deed contains the names of the trustee, their powers, the details of the trust property and other terms.
- (ii) In case of several trustees, all trustees must act jointly unless the trust deed provides for delegation of powers to some of the trustees.
- (iii) In case an account is opened for two or more trustees, the bank should obtain clear instructions as regards the person or persons who shall sign the cheques or other instruments. In the absence of such instructions all trustees must sign on each occasion.
- (iv) In the case of death or retirement of one or more of the trustees, the powers of surviving or remaining trustees will depend on the provisions of the trust deed.
- (v) In the event of retirement of all the trustees, the new trustees may be appointed by the court.

(vi) The insolvency of one or more trustees does not in any way affect trust property since it cannot be utilized for payment of the personal debt of the trustee.

(vii) The banker should not knowingly permit the misuse of trust funds, otherwise it can be held liable to the beneficiaries of the trust. For example, in a case, where the banker who had knowledge of the trust character of an account allowed the customer to transfer funds standing to the credit of the trust account to his personal account which was overdrawn, it was held that the banker was liable to pay the money to the account to which it really belonged.

(viii) In case of charitable trust, the banker should examine the registration certificate issued by the charity commissioner or such other authority as may be prescribed by the state Government concerned under the Public Trust Act.

## **MARRIED WOMAN**

A married woman does not suffer from any contractual incapacity except that only her personal estate can be held responsible for the contracts made by her. Thus a current account may be opened in the name of a married woman, but the banker will have no remedy against her if she overdraws her account and does not have any personal estate. The husband will not be responsible for any transaction, or debt of his wife unless:

- a. She acts as the agent of her husband or he has some interest in the transaction; or
- b. The debt has been taken by wife for purchasing certain articles of her necessities or those of the household which the husband has defaulted in providing her.

## **EXECUTORS AND ADMINISTRATORS**

Executors and administrators, both are persons appointed to settle the accounts of person after his death. Executor is appointed by the deceased himself, before his death. The person appointing him is called “testator”. The executor has to act according to the directions given in the will. However he must get the official confirmation of the will technically called as probate from court.

The administrator is appointed by court in those cases where the deceased has not given the name of executor in his will or person named as executor has died or refuses to act. He disposes of the assets and makes payment of the liabilities of the deceased as per the directions given in the will or in its absence in the letter of administration issued by the court appointing him as administrator. The banker should observe the following precautions while dealing with executors or administrators.

- a. The bank should examine the letter of probate (i.e official confirmation of the will) in case of executors and letter of administration in case of administrators to acquaint itself with the powers and functions of the executors or the administrators.
- b. An account in the following style may be opened in the name of executors or administrators.
- c. In case of joint executors or administrators the banker should get clear instructions, from them regarding the executors, administrators who will operate the account.
- d. The executors may borrow money for discharging some urgent obligations of the deceased. The executors or administrators are personally liable for such loans unless the banker has given loan on specific asset of the deceased. In case of joint executors or administrators the power to mortgage or pledge is available to all of them jointly. Moreover they cannot exercise such power if the probate or letter of administration specifically forbids it.

### **CUSTOMERS ATTORNEYS**

a person may by a written and stamped document appoint a person as his attorney to deal on his behalf with third parties. This power may be general or special. In case of a general power of attorney, the person appointing the attorney authorizes him to act on his behalf in more than one transaction. The power of attorney authorizing a person to sign cheques on behalf of the customer will be taken as a general power of attorney since it relates to more than one transaction. The banker while dealing with customers attorney should carefully examine the document regarding power of attorney. The customer may revoke the authority of the attorney by giving a public notice to that effect. The power of attorney is to be distinguished from an ordinary mandate which a customer gives to the banker to allow his nominee to operate his account.

### **JOINT ACCOUNTS**

A banker should keep in view following provisions while opening account in joint names:

- a. The account should be opened only on receiving application signed by all persons interested in the account.
- b. The banker should know how the joint account is to be conducted not only so far as withdrawals, are concerned, but also as regards other matters such as bill transactions, advances etc.

The clause regarding the operation of a joint account may be worded in any of the following ways, depending upon the intention of the parties:

1. When the intention is that all joint account holders should jointly operate the account. The account shall be operated by all jointly. In case of partnership firm the clause will run as follows: all partners to operate jointly.
2. When the intention is that anyone can operate the account: the account shall be operated by one survivor or survivors. In case of partnership firm the clause will run as follows: “any one partner can operate the account”.
- c. The joint account holders may allow some account holders out of them to operate joint account. But such authority shall stand automatically revoked on account of death, insanity or insolvency of any person giving the authority. Similarly, the authority to draw on a joint account can be revoked by the person giving the authority.
- d. In case of death of one or more joint account holders the balance in the account will vest with the survivor or survivors. On the death of all the joint account holders, any balance in the account is payable to the legal representative of the joint account holder who dies last, provided that no instructions to the contrary have been given.
- e. In case of insolvency of a joint account holder, the mandate given to the banks regarding operating the account will cease to be operative. Payment from the joint account shall then be made on the joint direction of official receiver of the insolvent account holder and the solvent account holders. Banks usually in such cases close the old account and open a new account, to record transactions after insolvency.

### **Joint account in the name of husband and wife**

The position in the case of a joint account in the name of husband and wife is different. Where an account is opened by the husband for his convenience, the balance cannot be claimed by the widow but has to be brought to the estate of the deceased. But where the intention of the husband by opening a joint account was to make a provision for his wife in case of his untimely death, the widow would receive the money.

### **PARTNERSHIP FIRM**

A partnership is the relations between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Persons who have entered into partnership with one another are called individually ‘partners’ and collectively a ‘firm’ and the name under which their business is carried on is called the firm’s name.

The bank should take the following precautions in the course of having business dealings with the firm.

- a. The banker should open an account in the name of partnership firm only when one or more partners make an application to the effect. However where the banker comes to know that a particular partner does not have the power to make such application to the bank on behalf of the firm the banker should not open the firm's account on an application made by such partner.
- b. The bank should ask for a copy of the partnership agreement and thoroughly acquaint itself with its clauses.
- c. The banker should take a letter signed by all the partners containing the following particulars:
  - The names and addresses of all the partners.
  - The nature of the firms business
  - The names of the partners authorized to operate the account in the name of the firm, including the authority to draw, endorse and accept bills and mortgage and sell property belonging to the firm.
- d. Any partner may by notice in writing to the banker, resolve the authority given to any other partner regarding operating the firms account. Similarly any partner can stop the payment of a cheque already issued and the banker will be bound to honour such instructions.
- e. The banker should not credit a cheque in the firms name to the personal account of the partner without enquiring from the other partners. In case he fails to do so he will be liable to the other partners for wrongful conversion of funds. However the bank need not make enquiries when a partner has drawn a cheque on his firm account and sends to the banker for credit to his personal account. But the bank should take due precaution when a partner sends such a cheque on being asked by the bank to clear the overdraft in his personal account.

### **Implied authority of a partner**

The authority of partner to bind the firm by his acts in the usual way of the business carried on by the firm is called the implied authority of a partner. In order to bind the firm it is necessary that:

- a. The act has been done in the name of the firm
- b. The act relates to the business of the firm
- c. The act has been done in a way so as to bind the firm.

The implied authority of a partner does not empower him to do the following:

- a. Submit a dispute relating to the business of the firm to arbitration.
- b. Open a bank account on behalf of the firm in his own name.
- c. Compromise or relinquish any claim of the firm.

- d. Withdraw a suit or proceeding filed on behalf of the firm.
- e. Admit any liability in a suit or proceeding against the firm.
- f. Acquire any immovable property on behalf of the firm.
- g. Transfer immovable property belonging to the firm.
- h. Enter into partnership on behalf of the firm.

the implied authority of a partner may be extended or restricted. Restrictions imposed on the implied authority of a partner by agreement shall be effective against a third party only when any of the following two conditions are satisfied.

- a. The third party knows about the restrictions.
- b. The third party does not know that he is dealing with a partner in the firm. Obviously in such a case he has no expectations from the firm and has no right to hold the firm liable if the partner exceeds his actual authority.

**Power to borrow.** In case of trading partnership firm every active partner has implied power to:

- a. Borrow money for the purpose of the firm
- b. Pledge the goods of the firm for the above purpose
- c. Draw, accept, endorse bills of exchange and other negotiable instruments.

A partner of a non trading firm can also borrow money and draw cheques for the purposes of the firm but he cannot draw, endorse a bill of exchange unless he has been expressly authorized to do so.

### **Payment of firm's debts and separate debts**

When there are joint debts due from the partnership and also any separate debt from any partner in the event of dissolution of the firm, firm's property must be first applied in payment of the debts of the firm and if there is any surplus, then the share of each partner in such surplus must be applied in payment of his separate debts or paid to him, if he has no debts.

The joint and several liability of the partners will come to an end in the following circumstances:

- a. When all the firm's debts have been discharged
- b. When there is reconstitution of the partnership firm.

### **Reconstitution of a partnership firm**

The provisions regarding reconstitution of a partnership firm and the bankers position can be summarized as follows:

**Retirement of a partner** – when a partner retires from a partnership firm, he will not be liable to the banker for liabilities incurred by the firm after his retirement. Similarly the other partners will also not be liable to the banker for his acts after retirement.

**Insolvency of a partner** – in the absence of any provision in the partnership agreement, a firm stands dissolved on the insolvency of any partner. The insolvent partner ceases to be a partner on the date the order of adjudication is made whether or not the firm is thereby dissolved.

**Death of a partner** – in the absence of any contract to the contrary, a partnership firm stands dissolved on the death of a partner. In case the firm continues to carry on the business after the death, the estate of the deceased is not liable for any act of the firm. The estate of the deceased partner continues to be liable for debts incurred by the firm before his death. The banker should therefore close the account of the firm on the date of the death and open a new account in the name of the firm. This will help in determining the liabilities of the firm on the date of the death of a partner.

## **JOINT STOCK COMPANIES**

A joint stock company has been defined as artificial person, invisible, intangible and existing only in contemplation of law. It is recognized as a separate entity as distinct from its members and enjoys perpetual succession.

A banker should take the following precautions before opening an account in the name of company.

1. Examination of documents
2. Copy of the boards resolution.
3. Borrowing powers of the company.
4. Registration of charges under the companies act.

## **SOCIETIES AND OTHER NON-TRADING INSTITUTIONS**

In case a society or an institution such as a school, a hospital wants to open an account in its name, the banker should take the following precautions:

1. The society must be incorporated
2. Resolution of the managing committee
3. Power to borrow

4. No mixing of personal account with the society.

## THE LAW OF TORTS

DuPlessis and O'Byrne define a tort as —any harm or injury caused by one person to another—other than through breach of contract—and for which the law provides a remedy.<sup>1</sup>

—Torts are civil wrongs for which the injured party may seek legal redressal for.<sup>1</sup> The injured party in case of torts is entitled to claim 'unliquidated damages', the judgment of which is given by the judge of a court based on the facts, circumstances and the amount of injury suffered which is actually suffered by the injured party. Tort law is largely based on common sense and the understanding prevalent between people in their everyday interactions with each other. The purpose of tort law is to ensure that people reasonably coexist with each other. In case of a tort case there are two parties involved in it i.e. plaintiff and defendant. **Plaintiff** is the person whose rights have been violated, the one who has been injured. He is the one who is the **complainant**, who comes to the court seeking remedy. On the other hand defendant is a person who has violated the rights of the other person and has injured the other person.

### Capacity in tort

Every person has a right to sue another person and every person can be sued by another person. In Kenya a minor can sue just like an adult, the only difference is that the tort action will have to be put forth and proceeded with, in court, by an adult acting on behalf of a minor. In case a minor is sued then, his parents or guardian will have to pay damages to the plaintiff, also the minor could be held liable. Also companies can be sued for the actions of its employees committed when acting as employees of the company i.e. on duty. The judicial authority cannot be sued if they are acting with their capacity. Also the government cannot be sued for any tort claim arising while it is acting within its governmental or sovereign capacity.

## GENERAL DEFENSES TO TORT CLAIMS

If someone sues one person claiming that the other person has violated the rights of his and has committed a tort, then certain defenses could be taken. The extent to which they apply against different torts, may, however, differ. Some of the defenses which can be used in torts are:

1. Volenti Non Fit Injuria: this means '**voluntary taking of a risk**'. It's when a person chooses to be in the situation that causes the injury.

2. **Plaintiff is the wrongdoer:** the most important thing in this case would be that the plaintiff did something wrong which caused him the injury.

3. **Inevitable accident:** When an injury is caused to a person by an event that could not be foreseen and avoided despite reasonable care on the part of the defendant, the defense of inevitable accident can be used.

4. **Act of God:** This defense is similar to the defense of inevitable accident according to me. The only difference is that in the defense of Act of God the accident happens to occur because of unforeseen natural event.

5. **Private defense:** If one injures someone, or something that belongs to someone else, while defending self or own property, then one can be excused if the force used to protect self was reasonable.

6. **Mistake:** Mistake is not usually a defense in tort law. It's not good enough to say that you didn't know you were doing something wrong. This defense can be used in case of malicious prosecution.

7. **Necessity:** In necessity, you have to show that the act you did was necessary in the circumstances.

8. **Act under Statutory Authority:** If the act done was under the authority of some statute that is a valid defense.

9. **Plaintiff's default/contributory negligence:** This defence may be relied upon if the plaintiff is also to blame for his suffering. The defendant must prove that:

- i. The plaintiff exposed himself to the danger/risk by act or omission
- ii. The plaintiff was at fault or negligent
- iii. The plaintiff's negligence or fault contributed to his suffering

This defence doesn't absolve the defendant from liability. It merely reduces the amount of damages payable by the defendant to the extent of the plaintiff's contribution. This defence is unavailable if the plaintiff is a child of tender years. If the plaintiffs were to sue and the defendant proved that the plaintiff was on the wrong, that can constitute a defense.

**Vicarious liability:** This deals where a person is liable for the acts of others. This happens where the person who committed the act did it on behalf of someone else. In this case of vicarious liability, both, the person at whose behest the act is done as well as the person who does the act is liable. Vicarious liability can arise from the following relationships:

### **Principal-Agent Relationship**

An agent is someone who is authorized to do an act by another person (principal) also the acts on his behalf. Both the principal and the servant are held liable. The difference between the master servant relation and principal agent relation is that in case of the latter the agent does not pass the direction and control test.

### **Partners**

In a partnership, the partners are responsible for each other's during the course of employment i.e. during the conduct of the business. The partners can be held responsible jointly and severally for each other's actions.

## **SPECIFIC TORTS**

### **NEGLIGENCE**

Negligence is a careless act that causes harm to another person. As with other torts, the victim is entitled to take legal action to be compensated for that loss or injury. While the term —professional negligencel is often used, there is no separate tort by that name; it merely refers to negligence committed by a professional person like an accountant or lawyer.

It is one of the most important in case of torts. This is because it is frequently committed. Tort is negligently committed, i.e. negligently causing nuisance, negligently trespassing on someone's land, etc. in order to establish the tort of negligence, it must be proved that:

1. The defendant owed a duty of care to the plaintiff
2. The defendant breached that duty, either totally or partially.
3. The plaintiff suffered damage as a result of this breach of duty.

### **Professionals liability**

**Professionals** have specialized knowledge and skills that clients rely on and are willing to pay for. The value of professional services lies in their capacity to reduce risk for the client. In defining liability for professional incompetence or negligence, the courts have tried to balance the social objective of assisting innocent victims with the need to avoid discouraging legitimate professional activity.

## **Nuisance**

## **THE TORT OF TRESPASS**

## **DEFAMATION**

## **EMPLOYMENT OF BANKS FUNDS**

### **Banks and liquidity**

The banks mainly obtain their funds from the various types of deposits from the public. Their own funds (share capital and reserves) constitute generally not more than 10% of their total funds. A banker has two important duties to its depositors.

1. It should pay them interest at the prescribed rates on their deposits.
2. It should pay their money as and when demanded by them.

Thus a banker has to see that the funds at its disposal are so invested that they remain fairly liquid as well as yield a reasonable rate of return.

### **Banks Liquid assets**

Liquid assets refer to assets which can be readily converted into cash (30 days or less) without any loss. These assets include;

1. Cash in hand – includes the cash balance maintained by the bank itself.

Factors that influence maintenance of cash balance:

- a. Growth of banking habit – the extent of dependence of people on banks for keeping their liquid resources determines to a certain extent the cash balance to be maintained by the banks. In case people prefer to settle their transactions through cheques, banks may not keep heavy cash balances with them.

- b. Conditions of the locality – a bank will have to keep a larger cash balance with it in case the locality is inhabited by business community who have numerous and rapid business transactions in comparison to a locality inhabited by agriculturists.
  - c. Existence of bankers clearing house – in a city where clearing house facility is available, bankers may maintain lower cash balances in comparison to cities without. This is because the existence of a clearing house enables the bank to settle its accounts with other banks simply by paying or receiving the difference of the cheques drawn in its favor.
  - d. Nature and number of accounts – the nature of deposits e.g savings, current and fixed. In case of fixed deposit account holders the bank do not need to maintain much cash balance with it. In case of current accounts it will have to keep a larger cash balance. In case of small number of big deposit holders, it will keep larger cash balance. In case of large number of small depositors, the banker may keep comparatively a smaller cash balance.
  - e. Nature of advance – a bank which has used a large portion of its surplus funds in discounting good bills can manage with a lower cash balance in comparison to a banker who invests its funds in other forms of loans. This is because such bills can be rediscounted easily with central bank.
  - f. **Reserve kept by other banks** – in case some banks in the same locality keep higher cash balance and win public confidence, the other banks will also follow suit.
2. **Statutory cash balance with central bank** - Under section 19 of the Banking Act, an institution shall maintain such minimum holding of liquid assets as the Central Bank may from time to time determine. Currently an institution is required to maintain a statutory minimum of twenty per cent (20%) of all its deposit liabilities, matured and short term liabilities in liquid assets.
  3. **Balance with other banks** – the scheduled banks besides maintaining cash balances with themselves or with central bank also maintain cash balances in current accounts with other banks as well as outside Kenya. The cash balances maintained by banks either with themselves or in central bank or other banks are the most liquid assets and therefore they can be rightly be termed as the first line of defence in times of trouble.
  4. **Money at call and short notice** – these loans represent mainly the loans given by one bank to another for a short period. Call loans are repayable at any time the banker recalls them while short notice advances are repayable within a short notice.
  5. **Investments** – banks also invest a significant portion of their funds in stock exchange securities. **Government securities** – these are the safest of all stock exchange securities. The price variations in their case is very narrow. They may be of three types:
    - Stocks – in case of stocks, a stock certificate is issued to its owner which indicates that his name has been registered with public debt office.

- Bearer bonds – these bonds certify that their bearer is entitled to a certain sum of money in respect of government debt.
- Promissory notes.

**Semi government securities** – these include debenture or bonds issued by quasi-government organizations. Eg improvement trusts, municipal corporations, state financial corporations etc.

**Gilt-edged securities** – they include government and semi-government securities.

**Shares and debentures of joint stock companies** – is done by commercial banks on a very marginal scale because of uncertainty both regarding return as well as value.

#### **Characteristics of ideal securities**

1. **Safety** – ensure that the principal money invested remains safe.
2. **Marketability** – easily marketable without loss.
3. **Price stability**.
4. **Income or yield** – ensure that security yields reasonable rate of return.
5. **Possibility of refinance** – ensure that security is such that on its basis it can refinance from central bank.

#### **ADVANCES**

Granting advances is the primary function of a bank. A major portion of its funds is used for this purpose

#### **CONSIDERATION FOR SOUND LENDING**

1. **LIQUIDITY** – since banks themselves heavily rely on borrowed funds and deposits they therefore prefer granting of short-term loans to their customers.
2. **Safety** – the capacity of the banker to repay money to its depositors depends upon its borrowers repaying capacity. The banker has therefore to see the safety of the advances made by it.
3. **Profitability** – the banker earns profit mainly through advances and therefore it cannot ignore the consideration of profitability while making advances.

#### **CONSIDERATION ABOUT CUSTOMER**

The banker while selecting his borrower should have a clear appraisal about the three C's character, capacity and capital.

- Character denotes integrity of the borrower.
- Capacity denotes his ability to manage his business.
- Capital denotes financial soundness.

#### **CONSIDERATION ABOUT PROPOSAL**

1. Purpose – the purpose to which the money is being borrowed.
2. Security – safeguard for unexpected defaults in repayments by the borrower.
3. Sources of repayment – the project advancing loan whether it will generate necessary cash to repay.
4. Term – period for which loan is required.

## **APPARAISAL OF PROJECT**

Project appraisal may be defined as a detailed evaluation of the project to determine technical feasibility, economic necessity, financial viability of the project and managerial competence required for its successful operation.

Such appraisal is done at two stages:

1. By the promoter for identifying the right project;
2. By the banker or financial institution for the purpose of determining whether the project should be financed or not.

### **Technical feasibility**

- a. Location of the project
- b. Technology used – has been tested and meets standards.
- c. Plant and equipment – suppliers of plant and equipment needed for the project are men of experience and reputation.
- d. Construction and installation schedules have been drawn out and they will be adhered to.

### **Economic necessity**

- a. The extent to which the market will absorb the additional production on account of the new project.
- b. The extent to which:
  - The project is expected to contribute to the national exchequer,
  - The project can bring about development in the area,
  - The project will create more employment,
  - The atmosphere and other pollutions could be contained.

### **Financial viability**

- a. Cost of the project – the estimates of the cost of the project should cover all items of the expenditure and should be realistic.
- b. Source of finance – source of finance contemplated by the promoters should be adequate and necessary finance should be available during installation as per schedule.

Financial institution give special emphasis to the following aspects while appraising the source of finance for a project.

- The promoter contribution
- The ratio between equity shares and preference shares should not be more than 3:1
- The debt equity ratio should be in the prescribed limits as provided by the finance ministry.
- Profitability – the project should start earning within a reasonable time. This requires finding of the break-even level or the level after which it will start yielding profit. This will also require application of various profitability tests such as ratio analysis. Financial institutions usually employ internal rate of return method for determination of profitability. It is the rate at which the present value of future cash inflows is equal to initial investment. In case the return comes to 15% or more, it is considered to be quite good. 13% to 15% considered satisfactory.
- Repayment capability
- Repayment schedule -

### **Managerial competence**

The technical competence, administrative ability, integrity and resourcefulness of borrowing concerns, top managerial personnel determines to as great extent the willingness or otherwise of a financial institution to accept a term loan proposal. The loan application from concerns having competent and honest management find the most favorable consideration.

The project appraisal is done by a financial institution to satisfy itself regarding the following:

1. The total estimated cost of the project is complete and reasonable.
2. The financial arrangement suggested in the project report is comprehensive and ensures availability of cash at the time of need.
3. The estimates regarding operating cost and earnings are realistic and reasonable and
4. The project will generate necessary cash required for repayment of the money borrowed.

### **FORMS OF ADVANCES**

The advances made by commercial banks can broadly be classified into two categories.

1. Loans, cash credits and overdrafts.
2. Bills discounted and purchased.

### **Loans**

A loan is a kind of advance made with or without security. In case of a loan the bank makes a lump sum payment to the borrower or credits his deposit account with the money advanced.

The rate of interest charged by a bank in the case of loans is usually lower than in case of cash credits and overdrafts on account of the following reasons:

1. It involves lower cost of maintenance on account of not frequent operation of the account.
2. The bank gets interest on the total amount sanctioned whether the customer withdraws the whole money or not.

### **Advantages of the loan system**

1. Observance of the financial discipline by the borrower.
2. Periodic review of loan account.
3. Simple and profitable. Banker charges interest on the total amount.

### **Limitations**

1. Inflexibility – the system is inflexible in the sense that every time a loan is required the banker has to negotiate with the borrower.
2. More formalities
3. Frequent renewals – though the loan is sanctioned only for a fixed period but in practice they are continuously renewed period after period. The review of the loan accounts generally becomes a casually in this process.

### **Cash credits**

Is an arrangement by which a banker allows his customer to borrow money up to a certain limit. Cash credits are usually made against the security of commodities hypothecated or pledged with the bank.

Hypothecation – in case of hypothecation, possession of goods is not given to the bank. The goods remain at the disposal and in the godowns of the borrower. The bank is given access to goods whenever it so desires. The borrower furnishes periodical return of stock with him to the bank. Such an advance is granted by the bank only to a person in whose integrity it has confidence.

Pledge – in the case of a pledge the goods are placed in the custody of the bank with its name on the godown where they are stored. The borrower has no right to deal with them. Customers favor hypothecation to pledge because the latter is considered to lower his prestige.

### **Advantages of cash credit system**

1. **Flexibility** – in case of a cash credit system, the customer need not borrow at once the whole of the amount he is likely to require but draw such amounts as and when required.
2. **Convenience** – banks have to maintain only one account for all transactions of the customer and hence repetitive documentation can be avoided.

### **Limitations**

1. **Mis-utilization of the credit limits** – cash credit limits are fixed once a year, it gives rise to the tendency of fixing a higher limit than the amount of funds required by the customer throughout the year.
2. **No verification of end-use funds** – in case of this system the banker lays greater emphasis on the security offered rather than the end use funds.
3. **Lack of proper management** – in case of this system it is not the banker but the borrower who decides when and how much he will borrow.

### **Overdrafts**

the customer maybe allowed to overdraw his current account, with or without security if he requires temporary accommodation. This arrangement, like the cash credit is advantageous to customers point of view as he is required to pay interest on actual amount used by him. A cash credit differs from an overdraft in the sense that the former is used for long term by commercial and industrial concerns doing regular business, while the latter is supposed to be a form of bank credit to be made use of occasionally and for shorter durations.

### **Bills discounted and purchased**

The bank also give advances to their customers by discounting their bills. The net amount after deducting the amount of discount is credited to the account of the customer. The bank may discount the bills with or without any security from the debtor in addition to the personal security of one or more persons already liable on the bill.

Example

Usance bills, maturing within 90 days or so after date or sight, are discounted by banks for approved parties. In case a bill, say for Rs. 10,000/- (approx. \$223 USD) due 90 days hence, is discounted today at 20% per annum, the borrower is paid Rs. 9,500/- (approx. \$211 USD), its present worth. However the full amount is collected from the drawee on maturity. The difference between the present worth and the amount of the bill represents earning of the banker for the period for which the bill is to run. In banking terminology this item of income is called "discount".

### **Collection of credit information**

1. Credit information bureau eg (CRB)
2. Borrower
3. Exchange of credit information by banks
4. Market reports – banks may make enquiries from the bankers and other businessmen about the credit-worthiness of a customer.

### **Factors limiting the level of advances**

A banks capacity to sanction advances depends on the following important factors:

1. The type of deposits – a bank gets a major portion of its funds through deposits, therefore the capacity of the bank to grant advances depends upon the type of deposits it has received.
2. Credit control by reserve bank.
3. Seasonal variations – in the busy season there is a higher demand for bank.
4. General business conditions – during boom periods where commercial and industrial activity is in full swing there is greater demand.

### **Consortium advances**

Several banks join together according to their capacities in meeting credit needs of large borrowers. Such a practice is also termed as participation financing of joint financing. There are two main reasons for such participation financing:

1. Limited resources
2. Diversification of risk.

### **RECALLING OF ADVANCES**

Recalling of advances sanctioned is the remedy of last resort. This may be done under the following circumstances:

1. If the borrower fails to renew the documents sufficiently before the expiry of the period of limitation.
2. If there is a material deterioration in the value of security or the quantum of turnover.
3. If borrower fails to maintain adequate margin with the bank inspite of persistent requests.
4. If the borrower refuses to lodge with the banker additional security to cover the amount withdrawn in excess of the limit.
5. If the borrower is guilty of misconduct or fraud causing serious damage to his credibility.
6. If there is a change in the policy of bank, central bank or government making necessary the recalling of advance.

## MODES OF CHARGING THE SECURITY

### Key Topics

- Lien
- Pledge
- Hypothecation
- Mortgage
- Assignment

### In Summary

- **Lien:** Lien means the right to retain the goods of the borrower until the debts are repaid.
- **Pledge:** Pledge is the bailment of goods as security for payment of a debt. Only movable goods can be pledged.
- **Hypothecation:** Hypothecation creates an equitable charge on movable property without possession. However, the hypothecation deed provides that the banker will have the right to take the goods hypothecated in its possession if the need arises.
- **Mortgage:** A mortgage is a conveyance of an interest in property (land or any immovable property) for securing a debt. A legal mortgage is created by a registered deed and gives the mortgagee the right of sale in case of default of the borrower.
- **Assignment:** Assignment is transfer of ownership from one person/authority to another person/authority.
- **Set-off:** Set-off means the total or partial merging of a claim of one person against another in a counter claim by the latter against the former.

## 1.0 Lien

Lien is the right of a creditor to retain the properties belonging to the debtor until debt due to him is repaid. Lien gives a person only a right to retain the possession of the goods and not the power to sell unless such a right is expressly conferred by statute or by custom or by usage. A banker's lien is a general lien which is tantamount to an implied pledge. It confers upon the banker the right to sell the securities after serving reasonable notice to the borrower

### 1.1 Kinds of Lien

- **A particular lien** applies to one transaction or certain transactions only.
- **General lien** gives a right to a person to retain the goods not only in respect of a particular debt but also in respect of the general balance due from the owner of the goods to the person exercising the right of lien. It extends to all transactions.

### 1.2 Negative Lien

**Negative Lien:** In case of negative lien. The possession of the security is with the debtor himself, who promises not to create any charge over them until the loan is repaid.

### 1.3 Banker's Lien

A banker's lien is always a general lien. A banker has a right to exercise both kinds of lien. A banker's lien is treated as an implied pledge: It must be noted that a banker's lien is generally described as an implied pledge. It means that a lien not only gives a right to retain the goods but also gives a right to sell the securities and goods of the customer after giving a reasonable notice to him. When the customer does not take any steps to clear his arrears. This right of sale is normally available only in the case of pledge. That is why lien is regarded as an implied pledge.

## 2.0 Pledge:

Section 172 of contract Act, 1872, defines a pledge as, the 'bailment of goods as security for payment of a debt or performance of a promise.'" Only movable goods can be pledged. From the above definition we observe that,

1. A pledge occurs when goods are delivered for getting advance,
2. The goods pledged will be returned to the owner on repayment of the debt,

3. The goods serve as security for the debt.

The person who transfers the goods is called pledger and to whom it is transferred is called the pledgee.

## **2.1 Essentials of pledge**

### **2.1.1 Delivery of goods:**

Delivery of goods is essential to complete a pledge. The delivery may be physical or symbolic. Physical delivery refers to physical transfer of goods from a pledger to the pledgee. Symbolic delivery requires no actual delivery of goods. But the possession of goods must be transferred to a pledgee. This may be done in any one of the ways:

1. Delivery of the key of the warehouse in which the goods are stored.
2. Delivery of the document of title to goods like bill of lading, Railway receipt, Warehouse warrant etc.
3. Delivery of transferable warehouse warrant if the goods are kept in a public warehouse.

### **2.1.2 Transfer of ownership:**

The ownership of goods remains with the pledger. The possession of the goods vests with pledgee till the loan is repaid.

### **2.1.3 Right in case of failure to repay:**

If the pledger fails to repay within the stipulated time, pledgee may,

1. sell the goods pledged after giving reasonable notice,
2. File a civil suit against the pledger for the amount due,

File a suit for the sale of the goods pledged and the realization of money due to him. When the pledgee decides to exercise the right of sale, he must issue a clear, specific and reasonable notice.

## **2.2 Precaution and general guidelines for pledgee**

1. The godown must be in good condition and well-constructed.
2. Godown must be effectively under Bank's control.

3. Name board of the bank should be placed outside and inside of the godown.
4. Letter from the party for free accesses to the godown by bank personnel (Bank's prescribed form) to be obtained.
5. Letter of disclaimer from the owner of godown is to be obtained if the godown is rented one.
6. Godown keeper and godown Chowkider are to be posted for receiving/ delivery and to ensure security of the goods.
7. Insurance of godown is to be done against all risks. Bank clause should be inserted.
8. Periodical Inspection by the authorized person of the bank (monthly/fortnightly) should be conducted.
9. Value of stocks must be determined at landed cost/invoice cost/market price whichever is lower as per Head office guideline (circulars).
10. Restricted item must not be accepted for pledge.
11. Deliveries and rotations of the stocks is to be made as per existing rules/procedures and terms and conditions contained in the sanction advice.
12. Market value of the goods pledged should be ascertained frequently in order to retain proper margin and allow withdrawals within drawing power. No upward revaluation without H.O. approval.
13. Pledged goods must be stocked properly to facilitate counting and checking.
14. Stock report card on each stock mentioning Nos. of bales, bags, cases etc. must be maintained.
15. In case of chemicals, drugs and medicines the date of expiry should be written and technical personnel must be employed to ensure its quality.

### **2.3 Accepting goods for pledge**

Before accepting the goods for pledge, banker should be satisfied that proposed pledge goods contain the attributes of a good security.

### **2.4 In the matter of pledge banks may be cheated in one or more of the following manners:**

- Pledge of spurious goods.
- Inflating the value of goods.
- Pledging the goods to more than one bank by using various entrances to the godowns.
- Fraudulent removal of goods with the connivance / due to the negligence of the bank's staff.
- Pledge of goods belonging to a third party.

## **2.5 Attributes of a good Tangible security**

1. Marketability
2. Easy ascertainment of value
3. Stability of value
4. Storability
5. Cost and labor of supervision
6. Transportability
7. Durability
8. Ascertainment of title
9. Easy transfer of title
10. Absence of contingent liability.
11. Yield

## **2.6 Documents required for Pledge:**

- Demand promissory note.
- Agreement for pledge.
- Letter of continuity.
- Letter of arrangement
- Insurance policy covering all risks.
- Invoice of goods pledged (for imported goods).
- Latest stock report.
- Letter of disclaimer
- Other documents as per sanction letter.

## **3.0 Hypothecation:**

Hypothecation creates an equitable charge on movable property without possession. The mortgage of movable property for securing a loan is called Hypothecation. In other words, in case of hypothecation, a charge over movable properties like goods, raw materials, goods in progress is created. Hypothecation is a charge against property for an amount of debt where neither ownership nor possession is passed to the creditor. Though the borrower is in actual physical possession, the constructive possession remains with the Bank as per the deed of hypothecation. The borrower holds the possession not in his own right as the owner of the goods but as the agent of the Bank. Being only an equitable charge on movable property

without possession, hypothecation facility is risky as clean advances. So it is granted only to parties of undoubted means with the highest integrity. Moreover, bankers insist upon for giving some sort of collateral securities.

### **3.1 Features of Hypothecation:**

- Charge against a property for an amount of debt,
- Goods remains in the possession of the borrower,
- Borrower binds himself to give possession of the hypothecated goods to the Bank when called upon to do so.
- It is a floating charge.
- It is rather precarious.

Being only an equitable charge on movable property without possession, hypothecation facility is risky as clean advances. So it is granted only to parties of undoubted means with the highest integrity.

### **3.2 Precaution and general guidelines for Hypothecation:**

As goods under hypothecation remains in the possession of the borrower, extra care has to be exercised to see that the bank's security is complete, adequate, safe and available at times when required. The banker should take the following precautions:

1. He must get stock statements periodically which contain a declaration by the borrower regarding his title to goods and correctness of the quality, quantity etc.
2. On the basis of the statement, he should inspect the stock and books of accounts of the borrower.
3. An undertaking from the debtor in writing, stating that he has not hypothecated the same goods to any other bank must be obtained.
4. The banker should get a letter of hypothecation containing several clauses to protect his interest under all circumstances.
5. The banker should insist on the borrower insuring the goods against the risks. He should also get it endorsed and assigned in his favour.
6. A board reading "Stock Hypothecated to X Bank" should be displayed in the place where the goods are stored.

### **3.3 In case of hypothecation bank may be cheated in the following ways:**

- The borrower declares wrongly the capacity of the storing place.
- A false platform between the loose stocks is erected.
- The borrower creates a hollow square in the middle of stocks. Kind of fraud is generally committed by the borrowers who have either built-up confidence with the bank or where the branch managers and other officials at the branch office have been got around by such borrowers.
- Often the borrower with intention to cheat the bank resorts to dumping deteriorated/obsolete stocks in between the good stocks.
- The borrower mixes inferior quality liquids or water with good liquids and commits fraud. The device is generally adopted by parties dealing in chemicals or oils.
- The borrower stores stocks of different qualities in the godown and cheats the bank. In such cases borrowers store goods of qualities different from these declared in lodgment memos.

#### **4.0 Mortgage**

- The transferor is called a 'mortgagor', the transferee a 'mortgagee', the principal money and interest of which payment is secured for the time being are called 'mortgage money', and the instrument (if any) by which the transfer is effected is called a 'mortgage deed'.
- A mortgage is a method of creating charge on immovable properties like land and building.
- Section 58 of the Transfer of Property Act 1882, define a mortgage as follows: "A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability."

#### **4.1 Characteristics of a Mortgage:**

In terms of the definition, the following are the characteristics of a mortgage:

1. A mortgage can be effected only on immovable property. Immovable property includes land, benefits that arise out of land and things attached to earth like trees, buildings and machinery. But a machine which is not permanently fixed to the earth and is shift able from one place to another is not considered to be immovable property.
2. A mortgage is the transfer of an interest in the specific immovable property. This means the owner transfers some of his rights only to the mortgagee. For example, the right to redeem the property mortgaged.

3. The object of transfer of interest in the property must be to secure a loan or performance of a contract which results in monetary obligation. Transfer of property for purposes other than the above will not amount to mortgage. For example, a property transferred to Liquidate prior debt will not constitute a mortgage.
4. The property to be mortgaged must be a specific one, i.e., it can be identified by its size, location, boundaries etc.
5. The actual possession of the mortgaged property is generally with the mortgager.
6. The interest in the mortgaged property is re-conveyed to the mortgager on repayment of the loan with interest due on.
7. In case, the mortgager fails to repay the loan, the mortgagee gets the right to recover the debt out of the sale proceeds of the mortgaged property.

#### **4.2 Forms of Mortgages**

Section 58 of the transfer of Property Act enumerates six kinds of mortgages:

1. Simple mortgage.
2. Mortgage by conditional sale.
3. Usufructuary mortgage.
4. English mortgage.
5. Mortgage by deposit of title deeds.
6. Anomalous mortgage.

#### **4.3 Rights of Mortgager**

1. Rights of Redemption
2. Accession to Mortgaged Property:
3. Right to Transfer to Third Party
4. Right to Inspection and Production of Documents

#### **4.4 Rights of Mortgagee**

1. Right to sue for mortgage money:
2. Right of sale:
3. Right of foreclosure:
4. Right of accession to property:

5. Right of possession:

#### 4.5 Sub-Mortgage

A sub-mortgage is created when the mortgagee gives the mortgaged property as security for advance. The mortgaged security is the property of the mortgagee and so he has the right to re-mortgage for securing loans. The sub-mortgagee is placed in the position of the original mortgagee and entitled to receive the mortgage money, sue for the property and realise, the security. Therefore, a sub-mortgage is also known as 'mortgage of mortgagee.'

#### 5.0 Assignment

- Assignment means transfer of any existing or future right, property or debt by one person to another person.
- The person who assigns the property is called assignor and the person to whom it is transferred is called assignee.
- Usually assignment are made of actionable claims such as book debts, insurance claims etc.
- In banking business, a borrower may assign to the banker

- i) The book debts,
- ii) Money due from government department
- iii) Insurance policies

#### 5.1 Type of Assignment

Assignment may be two types

1. **Legal Assignment:** A legal Assignment is an absolute transfer of actionable claim. It must be in writing signed by the assignor. The assignor informs his debtor in writing intimating the assignee's names and address. The assignee also gives a notice to the debtor and seeks a confirmation of the balance due.
2. **Equitable assignment:** An equitable assignment is one which does not fulfill all the above requirement.

In case of legal assignment, the assignee can sue in his own name. A legal assignee can also give a good discharge for the debt without the concurrence of the assignor.

## TYPES OF SECURITIES

### Types of Security & Modes/Ways of charging security

#### Types of Security

#### Modes of Charging security

##### Immovable Security:

Land, Building, Apartments, Factory Building, Heavy Machinery etc.

Mortgages.

##### Movable security:

Goods (Inventory) e.g. Raw materials, Work-in-progress and finished goods, Machineries, vehicles.

Hypothecation,

Pledge.

##### Financial obligations (Instruments):

Stock exchange securities.

Lien, Set-off

##### Actionable Claim:

Book Debt (Accounts Receivable), Supply Bill (Contract bill), Life Insurance Policy etc.

Assignment

##### Title to Goods:

Shipping Documents, Commercial Invoice, Transport Documents (Bill of Lading, Truck Receipt, Railway receipt), Insurance documents and Other documents.

Lien

## GENERAL PRINCIPLE

1. Adequacy of margin – in banking terminology margin implies the excess of market value of the security over the advance granted against it. For example, if the market value of security is sh500 and the advance granted against it is sh400 margin is sh100.

The banker must keep adequate margin while granting loans because of the following:

- The market value of the security is subject to fluctuations. In case of a fall in the value of the security, the interests of the bank are safe if there is an adequate margin.

- The security remains the same while advances against the borrower may go on increasing on account of non-payment of interest, charges etc.

**Factors determining margin.** The margin to be kept by a banker in respect of a particular security depends on several factors. Some of them are as follows:

- a. Fluctuations in the market prices. A banker will have to keep a larger margin in case of commodities whose prices are subject to greater fluctuations.
  - b. Financial soundness – in case of parties which are financially sound, a banker may keep a lower margin.
  - c. Central banks control – in case of commodities which are subject to central banks selective credit control the banker has to keep margin in accordance with the direction of central bank.
2. **Ready marketability** – a banker should accept such securities which are easily marketable without much loss in their value.
  3. **Documentation** – the banker should see that proper documents such as mortgage deed or the pledge agreement containing all terms and conditions of the mortgage or pledge are executed. This should be done in order to avoid future disputes.
  4. **Realization of advance** – the bank has to see that the loans advanced are realized on their becoming due. On default the banker may sell the securities after giving due notice to the borrower and use the money towards payment of the loans.
  5. **Continuing security clause** – in order to avoid the application of clayton's rule to the account of the borrower, the banker should get inserted the continuing security clause in the loan agreement. This implies that the property given by way of security will continue to secure the advances for which it has been given, though the balance in the account may fluctuate from time to time from debit to credit or credit to debit. Such a clause is inserted only in respect of fluctuating advances such as overdraft, pledge or hypothecation account and not in case of loan accounts.

## **ADVANCES AGAINST IMMOVABLE PROPERTIES**

Banks usually do not prefer to advance money on the security of immovable properties or real estates, e.g land and building etc. on account of the following reasons:

1. Difficulty to ascertain the title to the property – banker has to spend sufficient time and money to verify the title of the borrower to the property he is offering as security.

2. Not readily realizable – banks insist on liquidity. A real estate is not easily realizable without much loss.
3. Restrictive laws – various government laws restricting sale of land.
4. Valuation problem – the value of an immovable property depends upon its location, type of construction etc. banker may therefore have to employ qualified valuers for the purpose.
5. Legal formalities – a lot of legal formalities such as preparation of the mortgage deed, its registration, payment of stamp duty etc.

### **Precautions**

In case the banker decides to lend money on the security of immovable property it should take the following precautions:

- a. The borrower should be financially sound and the business for which money is borrowed be economically viable.
- b. The borrower should have a clear title of the property.
- c. The property should be properly valued. The value depends on several factors such as:
  - Ownership right i.e whether it is a freehold property or leasehold property.
  - The location of the property.
  - The type of construction.
  - The size structure and layout.
  - The rental value
  - Proper margin should be kept. Generally the margin is about 50% of the value of the property.
  - The property should be fully insured.

### **ADVANCES AGAINST GOODS**

About 2/3 of the total advances are sanctioned by banks against the security of goods which include food articles, industrial raw materials, plantation products, manufactured articles and minerals.

Goods have many distinct advantages over other forms of securities:

1. They are easily realizable on account of their having a ready market.
2. Their value can easily be ascertained from market.
3. They are tangible assets and therefore can be realized in case the necessity arises.

4. Loans against commodities are of a seasonal character. They are repaid before the commencement of the next season.
5. In case of commodities which are used as necessities of life, there is not much of price fluctuations.

**However goods as security have their own limitations**

1. Effective supervision over goods, may not be possible.
2. Quality of goods is difficult to verify.
3. Goods deteriorate in quality with passage of time resulting to erosion of banks security.
4. Heavy transportation costs may have to be incurred for realizing the best possible price for goods.

**Precautions**

- a. Selection of the borrower – banker should satisfy himself regarding the character, capacity and capital of the borrower. Since in case of goods, chances are more, this is all the more important.
- b. Selection of the commodities – commodities should those with fairly stable prices. Head office should have a list of such commodities.
- c. Charging the security – goods can be deposited by way of security either in the form of pledge or hypothecation.
- d. Storage of goods – following points should be taken into account while storing the goods offered by way of security:
  - The godown should safe water, fire etc. and situated un a good locality.
  - In case of hypothecation of goods the borrower should give an undertaking that he will allow inspection of godown and stock books as and when desired by the banks officials.
  - In case of pledge the godown should have a bank lock with the banks name engraved on it.
  - In case of payment of loan in installment it should be seen that the goods released are in proportion to the amount paid by the borrower.
  - The goods should be insured for full value.

**Illustration**

Mr B has been sanctioned and advance limit of sh 1 million against the security of goods valued sh 2 million. He proposes to insure the goods as required by the bank but only to the extent of the banks advance viz sh 1 million. How will you react to the proposition and why?

Mr B should be asked to get the goods insured for the full value. This is necessary for protection of the banks interest on account of the operation of the average clause which provides that in case of partial damage to the goods, the claim for loss will be reduced in that proportion which the insured valued of the goods bears to the actual value of the goods.

- e. Legal requirement – central bank guideline on granting loans against selective commodities.

### **ADVANCES AGAINST DOCUMENTS OF TITLE**

Documents which in ordinary course of trade, are regarded as proof of the possession or control of the goods are called documents of title. They authorize the holder thereof to transfer or receive goods which are mentioned therein. Bill of lading, dock warrants, a warehouse keeper certificate, railway receipts etc. since they are regarded as equivalent to possession of goods, they can be transferred just like goods either by mere delivery or by endorsement and delivery.

#### **Risks involved**

Granting of advances against documents of title involve the following risks in addition to the risks involved in case of advances against goods:

1. Possibility of frauds
2. Non-negotiability nature.
3. Obtaining delivery on the basis of indemnity bond – the borrower on the one hand may pledge the documents of title with the bank and on the other hand, manage to obtain the delivery of goods on the basis of indemnity bond or some other device. Thus the bankers risk increases.

#### **Precautions**

- a. Advances against documents should be made only to trusted and reliable borrowers
- b. The borrower should be asked to submit the complete set of documents such as bill of lading or railway receipt, invoice, bill of exchange etc.
- c. Carefully go through the documents to check.
- d. The borrower should be asked to sign an agreement with the bank pledging the documents with the bank.
- e. In case consignee fails to take delivery of goods, the bank should take over the goods in its control, store them properly and later on dispose them according to the direction of the borrower.

### **ADVANCES ON STOCK EXCHANGE SECURITIES**

They can be categorized as:

1. Government securities – issued by the government.
2. Corporate securities – issued by public limited companies.

### **Merits of stock exchange securities**

- a. Reliability
- b. Liquidity
- c. Price stability
- d. Easier valuation – since securities are quoted in the stock exchange the banker can ascertain their value quite easily.
- e. Transferability
- f. Regular recovery – dividend or interest which is received from time to time on these securities can be used for recovery of interest due on the loan or repayment of the principal itself.

### **Drawbacks of advancing money against stock exchange securities**

1. Liability to pay in case of partly paid up shares – in case partly paid up shares are transferred in the bankers name and the company makes a call, the banker will have to make call payment.
2. forgery –
3. fluctuations in prices –

### **Precautions**

1. Selection of securities – the following factors are considered:
  - a. Nature of company's business
  - b. Company's management
  - c. Past working results
  - d. Market trends in values of the shares of the company.
2. Valuation of securities - the valuation of corporate securities dealt on stock exchange can be done on the basis of daily stock exchange quotations. However the bank should also calculate the break-up value of the shares. While valuing these securities in case they quoted cum-dividend or cum interest, the amount of dividend or interest included in the price should be subtracted.
3. **Creation of charge** – the banker should finally get the securities charged in its favour. Such charge can be created in either of the two ways:

- a. By giving legal title – in cases of legal title the securities are transferred by the borrower to the bank in its name. the name of the banks or its nominess replaces the name of the borrower in companys records.
- b. **By creating an equitable title** – in case of equitable charge the borrower transfers the equitable title to the securities in favour of the bank by depositing the securities with it. the securities continue to stand in borrowers name in companys records. The equitable charge may be created by any of the following methods:
  - **By mere deposit of securities** – its not popular with the banks on account of likely complications that may arise in the absence of any written document.
  - **By memorandum of deposit** – the bank may obtain rom the borrower a memorandum stating that: the securities mentioned therein have been deposited by the borrower as security for the loan obtained from the bank, the bank will be entitled to sell the securities in the event of failure of borrower to repay the loan as per agreement and the banker will be entitled to debit the borrower's account with any amount that it might have to pay on calls.
  - **Blank transfer** – the customer may be required to deposit with the bank together with a blank transfer forms duly signed by him. In case of blank transfer the name of the transferee is not filled in the form. The advantage is that the bank may at any time fill its own name or that of any other person to whom it has sold the securities for recovering the loan.
  - **By power of attorney** – the power of attorney will empower the bank or its nominess to deal in the securities so deposited on behalf of the customers. The power of attorney will protect the banker from all possible risks.

### Risks in case of equitable charge

1. Existence of prior equitable title – an equitable charge becomes defective by a prior equitable charge or subsequent legal charge.

#### Illustration

Mary borrowed money from a bank on an equitable charge of shares registered in his name. later on it was found that she was holding shares only as trustee for her children. Since the childrens equitable charge was earlier than that of a bank, it was held that the bank could not recover its money out of the shares so charged.

2. Company's right of lien – in case articles give the company right of lien on its shares, it will have an adverse effect on bankers right of equitable charge.
3. Absence of information to the bank – since the borrower continues to be the registered holder of shares, he gets every information regarding issue of bonus shares, company's meeting, issue of right shares etc. the borrower may get bonus shares and may sell them directly. Thus bankers security is reduced.

### **Precautions**

1. The banker should generally accept only such shares under equitable charge which are the borrowers name.
2. The bank should give a notice to the company intimating about its charge over company's shares.
3. The banker should accept securities in good faith.
4. Bank should obtain in the memorandum the power to sell securities in case the need arises.
5. The banker should also obtain from the borrower a mandate addressed to the company directing it to pay dividends to the bank in respect of shares over which it has an equitable charge.

### **ADVANCES AGAINST LIFE INSURANCE POLICIES**

A life insurance policy is a contract in which one party (the insurer) agrees to give a certain sum upon the happening of a certain event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain periodical payment by another (insured)

1. The whole life policy – under this policy the premiums are payable throughout the life time of the life assured. The policy money is payable only on the death of the insured.
2. Endowment policy – the insured amount is payable to the insured on his attaining a specific age or on the predetermined date or in the event of his dying earlier, to his heirs or nominees.
3. Joint life policy – where two or more lives are insured jointly, insured amount shall become payable upon death of any one of the lives insured.

### **Merits of life insurance policy as a security**

- a. The policy can easily be assigned in favor of the bank.
- b. The valuation of the policy can easily be done.
- c. The value of security increases with the passage of time.
- d. The security can be easily realized. The banker can get the money by surrendering the policy to the corporation.

### Demerits

- a. A contract of insurance is a contract of absolute good faith. The insurer may repudiate the contract in case it is found that the insured obtained life insurance policy on concealment or misrepresentation of material facts.
- b. The surrender value of the policy is paid only when the insured pays premiums for a certain minimum period.
- c. Policy may contain certain onerous clauses such as suicide clause.

### Precautions

- a. Nature of policy
- b. Presence of insurable interest
- c. Admission of proof of age
- d. Preference for endowment policies
- e. No prior encumbrances
- f. Precautions regarding certain policies
- g. Ascertainment of surrender value
- h. Payment of premium.

## CONTRACTS OF INDEMNITY AND GUARANTEE

Contracts of indemnity and guarantee are of special significance for the bankers. In course of their business dealing banks may have to enter into contracts of indemnity and guarantee with other parties.

**Contract of indemnity** – is contract by which one party promises to save the other from loss caused to him by the conduct to the promiser himself, or by conduct of the third party.

*Illustration.* Mary who claims to have lost bank draft for sh200 issued by KCB in favor of Mike agrees to indemnify the bank against consequences of any proceedings which Mike may take against the bank. Mary will be termed as indemnifier and KCB as indemnity holder.

A contract of indemnity includes (1) only express promise to indemnify and (2) cases where loss is caused by conduct of the promisor himself or by the conduct of any other person. It does not include (1) implied promise to indemnify and (2) cases where the loss is caused by accident or by the conduct of the promisee.

## BANKS AND LETTERS OF INDEMNITY

The letters of indemnity are obtained by the banks in a number of situations.

1. Loss of term deposit receipt
2. Issue of a duplicate draft
3. Loss of travellers cheques
4. Loss of safe custody receipt
5. Loss of gift cheque

## **CONTRACTS OF GUARANTEE**

A contract of guarantee is a contract to perform the promise or discharge of liability of a third person in case of his default. The person who gives the guarantee is called the “surety”, the person in respect of whose default the guarantee is given is called “the principal debtor” and the person to whom the guarantee is given is called the creditor.

Contracts of guarantee are usually entered into:

- a. To secure the performances of something which may be immediately related to mercantile engagement.
- b. To secure the honesty and fidelity of someone who is to be appointed to some office.
- c. To secure someone from injury arising out of some wrong committed by another.

### **Essential of a valid contract must be present**

A contract of guarantee, like other ordinary contracts, must satisfy all the essentials of a contract, but it has two distinctive features:

1. Any promise made for the benefit of the principal debtor is presumed by law to be a sufficient consideration for the contract of guarantee.
2. In a contract of guarantee the creditor and surety must be competent to enter into a contract but principal debtor may be a minor or a person incapable of entering into a contract.
3. In a contract of guarantee, the liability of surety is conditional. It arises only when principal debtor makes a default. A liability which arises independently of a default is not within the definition of guarantee.

### **Invalid guarantee**

1. Guarantee obtained by misrepresentation.
2. Guarantee obtained by concealment

3. In cases of co-surety does not join – where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee will be invalid if that other person does not join.

### **Difference between a contract of indemnity and a contract of guarantee.**

1. Nature of liability – the person giving an indemnity is primarily liable where as the surety's liability is secondary, arising only on the default of another person.
2. Number of parties – a contract of indemnity is between two parties only indemnifier and indemnified. A contract of guarantee has three parties surety principal debtor and creditor.
3. Purpose of contract – guarantee is to provide necessary security to creditor against his advances but a contract of indemnity is made for reimbursement of loss.
4. Rights of parties – guarantee surety becomes entitled in law to proceed against the principal debtor in his own right after he has discharged the debt payable by principal debtor to the creditor. Indemnity indemnifier can bring the suit against third party only in the name of the indemnified.
5. Exercise of risk or liability – indemnifier promises to save the indemnity holder from contingent risk. But surety agrees to discharge the liability of the principal debtor which is not contingent but subsisting.
6. Parties interest – the person giving the guarantee should have no other interest in the transaction apart from his guarantee. Unlike in indemnity may have other interests *e.g a del credere agent*.

### **Kinds of guarantee**

1. Specific guarantee – means a guarantee for one specific transaction. In this case the liability of the surety extends only to a single transaction.

#### **Illustration**

KCB guarantees payment to B of price of five sacks of flour to be delivered by B to C and to be paid in a month. B delivers 5 sacks to C. C pays for them. Afterwards B delivers four sacks to C, which C does not pay. The guarantee given by KCB was only a specific guarantee and accordingly it is not liable for the price of four sacks.

2. Continuing guarantee – is that which extends to a series of transactions. surety can fix up a limit on his liability as to the time or amount of guarantee, when a guarantee is a continuing one.

### **Revocation of a continuing guarantee**

1. By notice
2. By death

### **Rights of the surety**

1. Right of the surety against the principal debtor
  - a. *Right to be subrogated* – when the principal debtor has committed the default and surety pays to the creditor, the surety will stand in the shoes of the creditor and will be invested with all the rights which the creditor has against debtor.
  - b. *Right to claim indemnity* – surety is entitled to recover from the principal debtor whatever sum he has rightfully paid.
2. Rights of the surety against the creditor – a surety has the right to benefit of every security which the creditor has against the debtor at the time when the contract of surety is entered into.
3. Right against co-sureties – when two or more persons stand as sureties for the same debt or obligation they are termed as co-sureties. The position of co-sureties is as follows
  - Co-sureties liable to contribute equally –
  - Liability of Co-sureties bound in different sums

### **Discharge of surety**

1. By notice or death – a contract of continuing guarantee may be terminated at any time by notice to the creditor.
2. Variations in the terms of the original contract between the principal debtor and the creditor.
3. By release or discharge of the principal debtor.
4. Compounding by creditor with the principal – if creditor makes a composition with, or promises to give time to or not to sue the principal debtor discharges the surety unless the surety assents to such contract.
5. Creditors act or omission impairing surety's eventual remedy – if the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to surety requires him to do, and eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged.
6. Loss of security
7. By invalidation of the contract of guarantee – if the contract of guarantee was obtained by fraud or concealment etc.

Note; every contract of guarantee must be supported by concurrence of all three parties. If a person becomes a surety without the consent and knowledge of the principal debtor, the contract of guarantee shall not be enforceable against the debtor.

### **SPECIAL TYPES OF GUARANTORS**

1. Minor's lunatics – The banker should not accept guarantees from such persons.
2. Insolvent parties - The banker should not accept guarantees from such persons.
3. Limited companies – the banker to verify from company's memorandum and articles whether the company has been given such powers.
4. Partnership firms – a partner of a partnership firm cannot bind his co-partners by giving guarantees for loans given by bank to other parties. However he can do so in the following circumstances:
  - a. It is a part of the ordinary business of the firm to give guarantee.
  - b. Definite authority has been given to a partner by his co-partners to give such guarantees.

The guarantee should be signed by the partner in the firm's name.

### **CENTRAL BANK OF KENYA**

#### **Establishment of the Bank**

The Central Bank of Kenya was established in 1966 through an Act of Parliament - the Central Bank of Kenya Act of 1966. The establishment of the Bank was a direct result of the desire among the three East African countries to have independent monetary and financial policies. This led to the collapse of the East Africa Currency Board (EACB) in mid 1960s.

#### **Structure of the Bank**

Responsibility for determining the policy of the Central Bank is given by the Central Bank of Kenya Act to the Board of Directors. The Board consists of seven members:

- the Governor, who is also its chairman
- the Deputy Governor, who is deputy chairman
- the Permanent Secretary to the Treasury who is a non-voting member
- five other non executive directors

All members are appointed by the President to hold office for a term of four years and are eligible for reappointment. In the case of the Governor, appointment is for a maximum of two terms of four years each and can only be terminated by a tribunal appointed by the President to investigate his conduct.

The executive management team comprises the Governor, the Deputy Governor and nine heads of department who report to the Governor. The Bank operates from its head office in Nairobi and has branch offices in Mombasa, Kisumu and Eldoret.

### **The Central Bank Act and its relations with the Government**

The Central Bank of Kenya Act of 1966 set out objectives and functions and gave the Central Bank limited autonomy. Since the amendment of the Central Bank of Kenya Act with effect from April 1997, the Central Bank operations have been brought into line with the changed situation in Kenya caused by economic reforms. There is now greater monetary autonomy.

Though required to support the general economic policy of the Government, the Central Bank of Kenya is not subject to any directive from the Government in exercising the powers conferred on it by the Central Bank of Kenya (Amendment) Act, 1996. However, both the Government and the Central Bank make mutual consultations on important policy matters.

The Central Bank, for example, is required to advise the Government on monetary policy matters of major importance and to provide information at the Governments' request. The Government in turn invites the Governor of the Central Bank to advise on fiscal issues that may have important ramifications on the Bank's monetary policy.

### **Mission of the Bank**

The Central Bank plays a unique role in the economy and performs various functions not normally carried out by commercial banks. The functions of the Bank have changed over time depending on the changing economic conditions. Currently its main task, as stipulated in the Central Bank of Kenya (Amendment Act), 1996 is; that of "maintaining price stability and fostering liquidity, solvency and proper functioning of a stable market-based financial system". As such it is responsible for formulating and executing monetary policy, supervising and regulating depository institutions, assisting the Kenya Government's financing operations and serving as Kenya Government banker. This is very much in line with contemporary central banking practice the world over.

### **Core functions**

#### **1. monetary policy –**

Monetary policy consists of decisions and actions taken by the Central Bank to ensure that the supply of money in the economy is consistent with growth and price objectives set by the government. The

objective of monetary policy is to maintain price stability in the economy. Price stability refers to maintenance of a low and stable inflation.

### **Importance of Maintaining Price Stability and economic growth**

Maintaining price stability is crucial for a proper functioning market-based economy. Low and stable inflation reduces the continuous rise in the general price level to such a level that it no longer adversely influences the decisions of consumers and producers. While, high rate of inflation inevitably give rise to a decline in the efficient working of a market economy and in the medium to longer term to a lower rate of growth of the economy as a whole.

### **How the Bank Ensures Price Stability**

As movements in the general price level are influenced by the amount of money in circulation, the Central Bank of Kenya operates in a way that restricts the growth of the total money stock available in the economy to predetermined growth target (See Monetary Policy Statement). There are three major tools the Bank uses to implement monetary policy:

**Open Market Operations:** through open market operations, the Bank buys or sells Kenya Government Treasury Bills both in the primary and secondary market in order to produce a desired level of Bank reserves. These securities are held in the Bank. The Bank therefore injects money to the economy when it buys Treasury Bills, and drains money when it sells it. As the law of supply and demand take over in the money market, the cost of loanable funds (interest rates) adjust itself to the desired level.

### **Discount window operations**

The Bank, as lender of last resort, may provide secured short-term loans to commercial banks temporarily in need of funds, but only after they have exhausted their market sources of funds. The discount rate is set by the Central Bank to reflect the monetary policy objectives.

### **Reserve Requirements**

The Central Bank is empowered by the Act to demand a certain proportion of commercial banks' deposits to be held as non-interest bearing reserves at the Central Bank. An increase in reserve requirements would be regarded as an attempt to restrict bank credit. A reduction in the reserve ratio would be viewed as an expansion of credit as it increases the credit creation power of the banks.

### **Other Functions of the Bank**

In addition to these primary tasks, the Central Bank performs other specific functions which have evolved with the changing economic environment since its inception in 1966:

## **2. Issue of notes and coins:**

The Central Bank of Kenya is entrusted with the making, issuing and destroying notes and coins in Kenya Shillings. The monopoly of issuing notes and coins enables it to exercise control over the money in circulation and thereby fulfill its primary task of safeguarding the domestic value of the Kenya shilling.

**Currency chests** – currency chests are receptacles (i.e boxes or containers) in which stocks of new or re-issuable notes are stored along with the coins. The money kept in currency chests is property is not deemed to be in circulation and is the property of the central bank. The strong room where currency chest is required to be kept should be securely built.

Advantages of bank or treasury maintaining a currency chest:

- Saving of loss of interest – banks are required to deposit their surplus funds with central bank. Unless these banks arrangements for immediate transfer of these funds, the surplus funds will remain idle with them resulting in loss of interest. Provision of this facility with the bank itself will solve this problem because the bank concerned will get the credit for the funds as soon as it deposits the amount in the currency chest.
- Maintenance of lower cash balance – a bank maintaining currency chest can work with lower cash balance in hand. It can withdraw money from the currency chest in case its payments on a particular day exceed its own balance.
- Efficient customer service – the chest enables the public to get their notes converted speedily into those of higher or lower denominations or get fresh notes in exchange of the soiled notes.
- Physical transfer of currency avoided – the availability of currency chest obviate the necessity of physical transfer of cash at frequent intervals, since funds can be taken out of one chest and put into another without much inconvenience.

## **five denominations of notes**

At present, the Central Bank issues five denominations of notes: Kshs 50, Kshs 100, Kshs 200, Kshs 500 and Kshs 1,000. While, new generation coins are in denominations of: 50 cents, Kshs 1, Kshs 5, 10kshs, 20ksh and Kshs 40 .

## **3. Provision of Banking services to Banks**

The Central Bank provides commercial banks clearing facilities of their cashless payments, a task laid down in the CBK amendment Act of promoting the smooth operation of payments, clearing and settlement systems.

#### **4. Bank Supervision –**

The Bank is also entrusted with the supervision of commercial banks in order to ensure efficient and sound financial system in the interest of depositors and the economy as a whole.

#### **5. Provision of Banking Services to Government:**

As banker and fiscal agent of Government, the Bank accepts deposits and effects payments on behalf of Government. It also maintains and operates special accounts for the Government. This function has, however, been circumscribed in the recent Central Bank (Amendment) Act of 1997 to prevent any erosion of the Bank's independence. Section 18(3) of the new Act limits access by the government to Central Bank credit, as this has been the major cause of monetary expansion in the economy [see the Monetary Policy Statement]. The Central Bank also administers the public debt, i.e. effecting issuance, payment of interest on, and redeeming of bonds and other securities of the Government.

#### **6. Foreign Exchange Operations**

The Central Bank holds official foreign exchange reserves of the country for the purposes of: repaying and servicing the country's public external debt; and intervening in the interbank foreign exchange market largely to smooth out erratic exchange rate fluctuations, thus helping to maintain orderly market conditions crucial for the shilling exchange rate stability.

7. Controller of credit – the reserve bank also functions as the controller of credit. It can control by various methods the creation of credit by commercial banks.

#### **Functions of CBK Branches**

To provide an efficient service to the banks and satisfy their requirements for bank notes, the Central Bank has opened branches in various regions of the country. The branch responsibility is to ensure that there is an adequate supply of new notes available to meet the demand, and to replace unfit notes.

#### **CONTROL OF CREDIT BY THE RESERVE BANK**

Control over creation of credit by commercial banks is one of the primary functions of the central bank of any country. No doubt credit is a must for trade and industry but excessive credit may lead to galloping

inflation and speculative tendencies. They have to be checked. The central bank of Kenya controls the volume of credit by different methods.

1. **Variation in the Bank rate**- is the interest charged on loans given to commercial banks by the central bank. It can be raised to reduce money in circulation or lowered to increase money in circulation. An increase in banking rate results in increase in lending rates of the commercial banks while decrease is vice versa. thus the former leads to contraction of credit while the latter leads to expansion of credit.
2. **Open market operations**-this involves the selling of government securities to reduce money in circulation or buying of such securities to increase money in circulation.
3. **Variation in Cash reserve** -this is the amount of cash that commercial banks are required to maintain in their accounts with the central bank of Kenya. It can be lowered to increase money in circulation or lowered to reduce money in circulation.
4. **Variation in the statutory liquidity requirements** - every commercial bank has to maintain in Kenya cash, gold or encumbered approved securities at least 25% of its time and demand liabilities. The central bank has power to change this minimum ration.
5. **Selective credit control**-this is where the central bank directs commercial banks to lend money to specific sectors of the economy.
6. **Margin requirement**-this is where the central bank may direct commercial banks to accept securities of higher value for one to be advanced a loan as a measure of lowering money in circulation or accept securities of lower value than the loans to be advanced to increase money in circulation
7. **Fixing of minimum and maximum lending rates** – the central bank also exercises control over credit by fixing minimum and maximum lending rates of interest by commercial banks.
8. **Moral persuasion**-the central bank appeal to other financial institutions to exercise restraint in lending money to the public. This is done through meetings, discussion, circular letters etc.

## **FRAUD – CLASSIFICATION**

### **Classification of Frauds**

- (a) Misappropriation and criminal breach of trust.
- (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- (c) Unauthorized credit facilities extended for reward or for illegal gratification.
- (d) Negligence and cash shortages.
- (e) Cheating and forgery.
- (f) Irregularities in foreign exchange transactions.

(g) Any other type of fraud not coming under the specific heads as above.

**THE END**