CUSTOMARY PRACTICES, LEGAL AND JUDICIAL FICTIONS RELATING TO BANKING AND NEGOTIABLE INSTRUMENTS

Dr. Wickrema Weerasooria
Former Professor of Law, Monash University, Australia
Insurance Ombudsman, Sri Lanka

Today, in August 2008 when one reads of banking and the business of banking, the topics we normally encounter are profitability, capital adequacy and stronger capitalization, asset quality, enhanced risk management, prudential regulatory supervision, new and innovative financial products, effective payments and settlement systems, transaction of cheques and their image clearance, credits and advances, non- performing loans, investments and deposit mobilization, internal and mobile banking, card – based payment modes, automated teller machines and new methods of information and communication technology.

The above topics are the ones highlighted in the annual reports of our main banks and the Central Bank's annual report which carries a review every year of our financial and banking sector. One of Sri Lanka's leading private commercial banks in its annual report gives the following description of its activities. It says :-

> The principal activities of the Bank continued to be banking and related activities of accepting deposits, personal banking, trade financing, off-shore banking, resident and non – resident foreign currency operations, travel related services, corporate and retail credit, project financing, lease financing, rural credit, issuing of local and international debit and credit cards, telebanking, bancassurance, internet banking, dealing in Government securities, bullion trading, export and domestic factoring etc.

The topics and subjects mentioned above are all ones that are subject to turbulence with the volatile changes in today's global economy especially with the rapidly rising price of crude oil. Hence, it is quite pertinent for this issue of this publication to concentrate on banking operations in turbulent times.

Notwithstanding this, and also notwithstanding the value and importance of the above topics and definitions, the purpose of this article is to take our minds back to about three hundred years ago and look at the origins of banking and the development of our negotiable instruments like bills of exchange and cheques, which for quite some time and to some extent even today, constitutes the bread and butter of banking business.

As an author of several texts on the Financial System and Banking Law, and as an academic who has taught banking law both in Sri Lanka and Australia for over forty years, I had been intrigued and fascinated with the historical development of the subject. Generally speaking, our modern day educational and teaching institutions gloss over the origins and historical development of subjects and rush into what is occurring now. In my view, this is not the best approach because there are many subjects that can be properly appreciated only if you get some understanding of their beginnings. Banking and Negotiable Instruments is one of such subjects. It is an area that was founded on customary practices of business and also studded with legal and judicial fictions and it is those aspects that I cover in this article.

For example, how many of the staff working in the banking industry in Sri Lanka know the origin of the word "bank" – the institution in which they work and earn a living. Surprisingly, I had difficulty in explaining the meaning of the term "bank" to my class of banking law students at Monash University in Australia but not to my Sri Lankan students. Why the difference ?

As we all know, Sri Lanka was under Portuguese rule from 1605 – 1796. As a result, many Portuguese words (which are derived from the Latin language) came into our vocabulary. One such word was "bankuwa" which means "bench". In Latin also, the word for "bench" was "banco" and the moneylenders of Italy used to sit on a "bench" (banco) in the village fairs (similar to the Sri Lankan "pola") and transact their business. When they (the money lender) had no more money to lend, the people at the fair symbolically signified this fact by breaking the bench (banco) on which the money lender sat. The meaning of "breaking" is "ruptus" (rupture). Hence, the term "bankruptcy" – the "banco" (bench) was "ruptus" (broken). This was then the origin of the term "bank" with which we are so familiar now. It basically meant the "bench" on which the money lender (now banker) sat. It is also noteworthy that the term bankruptcy though now commonly used for the debtor (borrower) having no money, originated from a lack of money of the creditor (lender).

It is fairly well established that modern "banking" as we know it today originated from the Italians. Also, banking was not conceptualized and put into practice by politicians, policy makers or Parliaments or by the Judges. Rather, it was conceptualized and put into practice by business people, by merchants and traders.

Many of you will remember the play the Merchant of Venice by William Shakespeare. That play has been translated into Sinhala as Venisiye Welenda. I used to prescribe this play as compulsory reading to my banking students at Monash University. It is all about borrowing, lending, debtors, creditors, guarantors and securities. The borrower/debtor in that play was the merchant (Bassanio); the creditor was Shylock and the guarantor was Antonio – Bassanio's friend. Like today's parate execution procedure where banks take steps to sell the property of the defaulting borrowers, in that play when the debtor (Bassanio) defaulted, Shylock bought Antonio, the guarantor, to court and wanted his property forfeited. However, in that play the "property" to be forfeited was not land or a house but was a pound of Antonio's flesh nearest his heart! That is what Antonio had (foolishly) guaranteed as the surety. We all know that the play ended well with the judgment of Portia. As the judge, Portia told Shylock that he could cut his pound of flesh but he was not allowed to spill a drop of blood. Thus, as a Judge, she made it impossible for the creditor (today's bank) to carry out the judgment against the guarantor because you cannot cut off flesh from a human body without spilling any blood. Portia's judgment sent a clear message to creditors that they must show a "quality of mercy" when suing their debtors. Our modern day judges should show the same quality of mercy to defaulting debtors that Portia displayed in that play.

Now, I would like to share with the readers of this article why and how I became interested in the origin and development of banking. Most practicing lawyers do not consider it necessary to do so. They take the view that if you know the current law well that it is sufficient. With great respect I disagree. Fortunately, I was not only a lawyer but a legal academic who had taught for over forty five years at Universities. In that job, my experience was that one never learns a subject as well as when you teach it and perhaps write on it as I have done. This is because the students at my lectures and those who read the texts I write want to know not only the basics of the subject but how the subject originated and developed. Thus, to me, a study of the historical aspect of any subject was a necessity. In this background, I also commend to others, what Sir Walter Scott said in his book Guy Mannering (1815). 'A lawyer without history or literature is a mechanic, a mere working mason; if on the other hand, he possesses some knowledge of the origin and development of a subject he may venture to call himself an architect'.

Now, let me turn to some other topics that concern bankers. No banker will argue or disagree with me if I say that basically bank lending relates to money, credit and debt. Any type of bank lending involves these three components.

There may, however, be occasions where a bank 'lends money' but in a strict sense no money passes to the borrower. A good example is a bank guarantee or performance bond. Here the bank *only* lends its name and undertakes to pay money *only* if the borrower defaults. Next, although modern day bankers often use sophisticated lending products such as syndicated loans, securitization, commercial paper, debentures, floating charges, leasing, derivatives, swaps, options, futures, etc. ultimately even these innovative techniques of lending must be boiled down to the elementary notions of money, credit and debt. As Alan Greenspan, the respected former Chairman of the US Federal Reserve Board has emphasized:

> Derivatives, securitization and mutual funds management and the like are the new horizons in banking. But these activities which are regarded as new by casual observers are, in fact, often merely extensions of different forms of the basic business of banking, which is to measure, price, manage and accept various forms of risk especially credit risk. Unfortunately,

in the process of focusing on the new, bankers often lose sight of how important is the old – that is, good old-fashioned lending. (A Greenspan, 'New Horizons for the Basic Business of Banking', The *Journal of Commercial Lending*, December 1994, p 10). In endeavouring to understand a subject, one must not lose the wood for the trees. The 'wood' always remains money, credit and debt, while the 'trees' can be categorized as the lending products and securities devised by modern day banks and other financiers.

"Money" and "Legal Tender"

Now I turn to a brief discussion of the meaning of the terms "money" and "legal tender". The dictionary meaning of money is a "current medium of exchange in the form of portable pieces of stamped metal; this and promissory documents representing it, especially government and bank notes". Clearly, this meaning is not only limited but also outdated. The economists' meaning of money is also too broad for legal purposes. Economists look upon money as a medium of exchange, a unit of account or as a way of holding wealth. They emphasise portability, divisibility, durability and stability in value. The legal concept of money is narrower. In modern times, the primary function of money is to serve as a medium of exchange, and as such it is accepted without question in final discharge of debts or payment for goods or services.

In a concrete sense, the term money generally includes currency as well as coins, although it may be limited to such of each as are legal tender at the time and place in question. The term is sometimes used to include not only actual cash but also a right to receive cash, for example, sums standing to the credit of a bank account or investments in securities, and the term may in some cases be used in a popular sense to include all personal property, or even, exceptionally, all real and personal property. There can be no hard and fast rules as to its meaning. Professor Mann, in his classic text *The Legal Aspects of Money* (5th ed, Clarendon Press, Oxford, 1992, pp 3-6) states:

> There is no law of money that is common to all the countries of the world. But money is a universal institution... Money is a term so frequently used and of such importance that one is apt to overlook its inherent difficulties, and to forget that the multitude of its functions had led to a multitude of meanings ... Consequently, it is necessary *to examine its meaning in each individual context* ...

Judicial interpretation of "Money"

According to case law, the courts have also recognized that the term "money" may have different meanings in different contexts. A narrow meaning is given to it when used in criminal law and an intermediate meaning when used in legal actions for money paid or for money had and received. On the other hand, the term "money" has received a wide meaning when used in a last will – to give effect to the intention of the testator. In the English case of *Perrin v Morgan* [1943] AC 399 at 406-8 Viscount Simon, the Lord Chancellor of England, in the course of dealing with the definition of the term 'money' as used in testamentary dispositions, gave the following account which has now become famous. His Lordship said:

> The word 'money' has not one natural or usual meaning but several meanings. In its original sense, which is also its narrowest, the word means 'coin'.
>
> The term 'money' is derived from the word 'moneta' and the Temple of Moneta dedicated to the Greek goddess Juno was the government *Mint* in Rome. By the passage of time the term 'money' was popularly used for "cash" of any sort. "Have you any money in your purse or pocket" refers to both currency notes or coin. People also refer to "my money at the bank" – although strictly speaking, when you have a bank account, the money in that account belongs not to you but to the bank. The only right you have as the depositor / customer is a <u>chose in action</u>, for any monies from the account.
>
> People also make statements such as 'I have my money invested in mortgages, or in debentures, or in stocks and shares, or in savings certificates. This is not an illegitimate use of the word 'money', though it is a great extension from its original meaning to interpret it as covering securities.
>
> The word may be used to cover the whole of an individual's personal property – sometimes, indeed, all of a person's property, whether real or personal. 'What has he done with his money?' may well be an inquiry as to the general contents of a rich person's will.
>
> Because of these popular meanings, wider meanings and more restricted meanings, *the duty of the Court, in the case of an ordinary English word such as 'money', is not to assume that one out of several meanings holds the field as the correct meaning until it is ousted by some other meaning regarded as 'non-legal'; but to ascertain without prejudice as between various usual meanings which is the correct interpretation of the word in a particular document.*

Today the common law meaning of money is a broad one. The term includes bills of exchange, cheques and other forms of negotiable instruments and also credit balances in bank accounts. In *Moss v Hancock* [1899] 2 QB 111 at 116 – Justice Darling approved the following definition of money:

That which passes freely from hand to hand throughout the community in final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it in discharge of debts or payment for commodities.

Legal Tender and Settlement of Debts by Cheques

Let me now consider how debts can be settled legally in Sri Lanka. Technically and legally payment and settlement of a debt must be by legal tender. The Courts have interpreted the term "legal tender" to mean the prescribed mode of lawful payment within a particular country. In Sri Lanka, Section 52 of our Monetary Law Act states that "all currency notes and coins issued by the Central Bank shall be legal tender for the payment of any amount".

Then, does this mean that only Sri Lankan currency or coin can be used to settle debts etc? The answer is that the Courts globally and here have recognized other popular means of payment such as by cheque etc as a way of settling debts on the condition that the persons involved in the transaction – the debtor and the creditor – have agreed to such a mode of payment as constituting legal tender. There are several judicial decisions in support of this view. This is why cheques are now commonly accepted in settlement of debts. Similarly, electronic funds transfer and payment by credit card constitute legal tender if the parties to the transaction so agree. People normally agree to payment by cheques or by electronic means because otherwise it is difficult or impossible to deal only in currency. No one likes to carry or keep cash (currency) because it can be misplaced, lost or stolen. However, it is always a decision for the parties to a transaction as to how payment should be made. There are creditors and traders who refuse to accept payment cheques or credit cards and insist on cash (legal tender).

As stated above, payment by cheque to discharge debts is now very popular and is the common practice. However, the legal position is that when a cheque is issued in payment, the payment is conditional until the cheque is realized (paid or honoured) by the drawer's bank. Secondly, when payment is effected by electronic remittance, the debt is not discharged by the mere remittance or credit transfer. The creditor's (payee's) bank must receive the payment. Then only the payment is treated as complete. There is plenty of case–law to support the above propositions.

Dishonour of cheques for want of frauds by the issuer of the cheque is increasing. Hence, creditors are reluctant to accept personal cheques in payment. Landlord and tenant issues are good examples that have highlighted payment by cheques. In this connection, several Sri Lankan judicial decisions have settled cases relating to *payment of rent* by cheque. Not paying rent by the due date is a ground to file action to eject a tenant. Some tenants wish to pay their rent by cheques. Landlords have the discretion to accept a cheque or insist on cash. If the landlord accepts a cheque and gives a receipt and the cheque is dishonoured for lack of funds etc. the landlord cannot thereafter argue that the rent was not paid on the due date. This is because of the receipt he gave. In such a case, the landlord can take action on the 'unpaid' cheque but he cannot sue for ejectment for non-payment of rent on the due date. Lawyers have advised landlords about the above legal position in accepting cheques as payment of rent and today such issues rarely arise.

Special qualities of Negotiable Instruments

Today in 2008, where would we be if not for negotiable instruments like bills of exchange, cheques and promissory notes. If we had to conduct transactions by the movement of bullion (gold and silver etc.) or by cash (currency and coin) – business will come to a standstill. Also, no Reserve Bank (Central Bank) in any country prints or mints the total requirement of that country's currency and coin. Rather, they rely on the banking industry to create the required "money" and this is done mainly through cheques and other negotiable instruments. As an illustration, as a general rule, payment for a car is not made by cash, but by a cheque.

In the early days debts had to be settled by gold or silver but this was risky and cumbersome to transport when payment had to be made in another place or another country. Also, the common law rule "Nemo dat quod non habet" (no one can give that which he has not got) applied. This rule did not apply to negotiable instruments which the courts defined as "instruments that could be transferred by mere delivery and endorsement: The transferee who took the instrument in good faith and for value, became its true owner despite any defect of title in the transferor".

As a practical illustration, take a watch. Ownership in the watch can only pass if there is an intention to do so. Possession is not sufficient and, if the watch is lost or stolen and passed on through several hands, the original owner at no time loses ownership and may claim possession from the present holder. The watch is a non-negotiable article; title to it is not transferred by delivery alone.

A cheque on the other hand, he/she a negotiable instrument. If the cheque is lost or stolen and comes into the possession of a person who takes it in *good faith and for value and innocent of the defect in title* of the transferor, she becomes the true owner of the cheque. Both the watch and the cheque are transferable but only the cheque has the quality of negotiability. It is this legal difference that made negotiable instruments so popular.

In modern times, apart from bills of exchange, cheques and promissory notes, the following have been recognized as negotiable, namely, banknotes, exchequer bills, dividend warrants, bearer bonds, bearer debentures, savings certificates, warehouse certificates and travellers cheques. On the other hand, there are many familiar documents which have been held not to possess all the characteristics of a negotiable instrument and are therefore not negotiable. For example, share certificates, money orders, postal orders, bankers' deposit notes, commercial letters of credit, IOUs, bills of lading etc.

Credit Cards and "Wallets" in Mobile Phones

While the negotiable instrument (a piece of paper) soon took the place of bullion (gold or silver) and later currency and coin – as the method of effecting payments, more recently even such negotiable instruments are being replaced by plastic credit cards making the world a "cashless society". Soon the rapid development of computer technology, the Internet and Telecommunication inputs may make the "mobile phone" the most popular payment system. We see billboards on our own highways with Sri Lankan cricketing star Sanath Jayasuriya proudly *showing his mobile phone and saying* "My cash is in my Wallet", indicating transfer of funds through his mobile phone. In the year 2008 Sri Lanka had over five major operators of mobile phones – led by Dialog – with a total number of nearly nine million mobile phones in operation despite a government levy on such phones.

Legal Fictions in Banking

Apart from the above noted <u>Customary Practices</u> that evolved in banking and payment systems, there are legal fictions – both judicial and statutory. A "fiction" is something that is assumed to be true. For example, a "company" has no physical existence like a human being. However, from the very inception, the law has assumed a company to have a "legal existence" like a human being. Thus, when we regard – a "company" as a "legal entity" that can sue or be sued, we are giving effect to a well-established legal fiction.

As a another example, take depositors / customers money in a bank account. Although technically the money is that of the customer, the law assumes that from the moment of the acceptance of the deposit by the bank, that money becomes the money of the bank and the bank can do whatever it wants with that money. For example, the customer cannot dictate to the bank to whom and for what purpose the bank can lend that money. Then what is the legal right of the customer to the money so deposited ? All that the customer has is what is called a <u>chose in action</u> (a right of action) to get bank that money when he wants it. This he can do by making a demand which is usually done by writing a cheque or presenting his savings book (if it is a savings account). These are also legal fictions established by case-law.

The impact and influence of customary practices and legal fictions on banking was further elaborated by me on 30th June 2008. When the Association of Professional Bankers launched a book compiled by me on "Customary Banking Practices on Customer Account Operations". At the ceremony launching of that book (at which the chief guest was Supreme Court Judge Mr. Saleem Marsoof, President's Counsel), I explained why and how that publication came to be compiled and issued.

Twenty years ago, in 1988, when our Banking Act was enacted many noticed a curious and unusual statutory definition of "banking business". Normally, what constitutes the "business of banking" is left to common law or to judicial decisions. That is the position in England and other countries where the English law of banking applies, for example, in Australia/New Zealand, Canada and the United State.

But for some reason the draftsman of our Banking Act of No 30 of 1988 had in section 86 of the Act defined "banking business" as follows;

> "Banking business" means the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise, and the use of such funds either in whole or in part for advances, investments or any other operation either authorised by law or <u>by customary banking practices.</u> (My emphasis)

One can understand "operations authorised by law" but what was curious were the words operations authorised "by customary banking practices".

In September 1988, when the Banking Act came into operation no one raised any serious objections to this definition. It was also the first time that Sri Lanka saw a comprehensive Act on Banking. That Act also settled the issue as to who can function as "a Bank". The Act lays down that to be a bank you must firstly be an incorporated company and secondly you must apply and obtain a license from the Central Bank. Without satisfying these two requirements no person in Sri Lanka can carry on the business of banking or use the words 'bank', 'banker' or 'banking'.

However, over the years banking business has developed rapidly and it has become necessary that the term "customary banking practices" as used in Section 86 of the banking Act be defined or explained.

As a practical issue, any Judge in a given case can ask "are these operations of your bank which are in dispute, customary banking practices"? This is because if any operations of a bank are not part of the "business of banking" then our common law, the Roman Dutch law (and not English law) will apply to govern that transaction. I will refer to this issue later.

In that context, as far back the end of 1990^{s}, when I was at Monash University in Australia, the Association of Professional Bankers had requested me to identify the "customary banking practices" in Sri Lanka. This process took a long time and now at last this book is published. This was the origin of the publication that was inaugurated.

At that inauguration, I also stated that negotiable instruments such as Bills of Exchange, Promissory Notes and Cheques also originated like Banking, from the Usage of Merchants. The rules relating to them were originally called the Law Merchant or the Lex Mercatoria – which simply means "Mercantile Custom".

The Law Merchant was gradually recognized by the English courts and was adopted and incorporated into English Common Law. One well-known Judge, who was responsible for this was Lord Mansfield, the Chief Justice of England in the mid 18th century. It is recorded that Lord

Mansfield was so fascinated by the Law Merchant that he used to dine with English and European merchants to learn more about these customs and usages.

Thereafter in 1882, an English lawyer called Mackenzie Chalmers who served for sometime as a British Civil Servant in India drafted the Bills of Exchange Act. Believe it or not Chalmers is said to have gone through over 2500 judicial decisions from the law reports – even some American cases. He then distilled the legal principles from those 2500 cases into one hundred sections of the Bills of Exchange Act (BEA). In my view, Chalmers did something remarkable. He took the important decisions from over 2500 cases and formulated them into not more than one hundred statutory sections. The BEA is said to be the best drafted Act ever. Chalmers was later knighted for this task. Subsequently, he was asked and he drafted the Sale of Goods Act as well. Both these Acts apply in Sri Lanka.

Bankers should also be grateful to some famous English Judges of the early 19th century who overcame fundamental problems banks faced by applying "Judicial Fictions". I mention here the names of English Judges like Justice Atkin, Justice Scrutton, Justice Bankes and Justice Diplock.

For example these Judges held (i) that a customer must make a demand before he can withdraw money deposited with his banker. The demand is normally made by a cheque or presentation of the passbook. Without such demand, the bank is not liable to repay. Secondly, they said that a cheque can be converted. To the argument that conversion applies only to items of value and a cheque is a mere piece of paper of no monetary value, the English Court said – the value of the cheque is the value for which it is written and not the value of the piece of paper and therefore it is valuable and capable of conversion. Both the above explanations – the need for a demand and that a cheque is chattel because it is valuable in money terms were indeed Judicial Fictions.

In the accounts I have related above, I have shown that the Business of Banking was truly the Customs and Practices of Merchants. But now in modern times banking business has seen a rapid development and bankers have truly become financial intermediaries. As I showed at the very beginning, their core business which was dealing in bills of exchange and cheques has changed to other areas such as lending and handling investments and putting together or structuring loans or handling public share issues. Bankers can now be found in any money making venture.

At the inauguration ceremony of that Publication I also emphasized that Sri Lanka is one of three countries in the World – there are now 194 countries – that have Roman Dutch Law as its common law. (South Africa, Zimbabwe and Sri Lanka) Thus, while English Law applies to banks and banking, any subject – not covered by the "business of banking" will be governed by Roman Dutch Law.

In cases decided some years ago, our Supreme Court had held that the lending of money, the taking of pledges and mortgages, the taking of guarantees and the safe custody of articles (which in law is called "bailment") are all governed in Sri Lanka by Roman Dutch Law - and not English Law.

But what about common day-to-day banking activities such as Banker's Opinions, also called Banker's References or Credit Reports and the Safe Custody of Valuables for their customers. Are they part of "Customary Banking Practice?" If so, in my view, such activity will be governed by English law. If not, they will be governed by Roman Dutch Law.

If one really wishes to know the difficulties faced by banks by this conflict whether it is English Law or Roman Dutch Law that applies to a transaction concerning a Bank or Negotiable Instrument, one should read the judgment of our Supreme Court in the case of De Costa v Bank of Ceylon decided in 1969 by a Full Bench of our Supreme Court (5 Judges) and reported in 72 New Law Reports at pages 457 – 548 (91 pages).

Briefly stated, in that case a collecting bank (Bank of Ceylon) had collected a negotiable instrument. (a dividend warrant for Rs. 30,637/-) for its customer who had stolen it. The "true owner" of the instrument sued the Bank for conversion. For the Bank it was argued that the dispute should be settled by Roman Dutch Law; that conversion was unknown to Roman Dutch Law; and hence the Bank should be acquitted of liability. A Full Bench of the Supreme Court was constituted by the then Chief Justice to hear the appeal because there were two conflicting earlier decisions as to whether the tort of conversion applied in Sri Lanka since Roman Dutch Law did not recognize such a tort.

In what is perhaps one of the best judgments delivered on a banking or commercial Law matter, our Supreme court held that conversion of a cheque by a bank should be governed by English Law and not Roman Dutch Law because;

(i) it was a matter related to Negotiable Instruments to which English Law applied; and/or
(ii) the conversion was by a bank and the law governing banks and banking was English Law.

What I have outlined above shows how banking and bills of exchange originated and how important it is for the banking industry in Sri Lanka to ensure that all banking transactions are governed as far as possible by English Law. I also endeavoured to show that to a large extent banking activities and the conduct of business through the medium of negotiable instruments were all originally based on customs and practices of merchants and traders, now popularly referred to as businessmen.