BANK CONTRACTS AND IMPLICATIONS

THE CONTRACT

The legal relationship between a banker and a customer is expressed in a contract which is in writing. Such contracts contain a promise by the bank to lend money, to establish a line of credit or to provide some other finance facility such as a bank guarantee. The customer on the other hand promises to repay the loan with the agreed amount of interest, or to maintain the credit line within agreed limits and ultimately to repay the amount then due.

Contracts with a bank (mortgages, charges, guarantees, etc.) have in addition what are known as **"all money clauses"** and it is very important to understand what they are. We tend to think that a mortgage, only secures the facility which is mentioned in the mortgage; the truth is that it secures **all other monies owed by the borrower**. It will for example secure an unsecured loan, a line of credit on a credit card, and moneys due to the bank under a leasing arrangement, and so on. In fact, if you have given a security to your bank for one facility then you have effectively given it for all. The bank may not explain this to you unless you ask.

ARE ANY ASSETS PROTECTED FROM THE BANK IN THE EVENT OF DEFAULT?

The short answer is, no! As previously mentioned the bank can exercise its rights over the security which you have given, sue on the personal covenants to gain access to your other assets by way of a writ of execution and for that matter by sending you bankrupt.

A bank is entitled to be repaid any money owed. A borrower when signing bank documents should be aware of their full effect.

MORTGAGES OVER REAL ESTATE

The earliest mortgages involved the transfer of the ownership of the security/ land subject to the borrower being entitled to a retransfer upon repayment of the debt. In fact, this is still the

form of many mortgages today. However, in the case of mortgages over Torrens Title land, the mortgage only operates as a charge over the real estate.

***Personal obligations**

Promises to lend money by the bank and promises to repay by the customers are commonly known as personal covenants. A failure on the part of customers to fulfil their promise is a breach of the contract and in such cases the bank can sue on the personal covenants to recover the money due to it. Similarly, customers can sue the bank.

* **Security**

To make sure that it will be able to recover moneys lent to customers, the bank normally requires security over real estate. A security involves a covenant of a different kind. It is a backup promise in case the promise to repay the debt is not fulfilled. It is a promise which will allow the bank to sell or otherwise deal with the security in accordance with the terms of the contract in the event of default.

These provisions permit the bank to deal with the security in a variety of ways. Except in the case of foreclosure, the bank can sue to recover any balance outstanding after having dealt with the security. The usual ways of dealing with the security are to:

* take possession of the security/property

* sell the security/property

* grant a lease of the security/property to a third party
* appoint a receiver to the security/ property

* foreclose. This is a remedy normally available to a bank which is slightly different in that it involves acquiring title to the security/property in total satisfaction of the outstanding debt, where after the bank has no further recourse against the customer.

Other Provisions

In order to preserve the value of the security the bank will have the right to refuse the owner/borrower the right to lease the land without the bank's consent. Whilst the law says that consent cannot be unreasonably withheld, it could be expected that a bank might refuse consent if the lease would effectively reduce the value. Such a case would be if the lease were for an extended period and had no provision for rent review or if the rent is below the market value. In fact, the mortgage will preclude almost all dealings involving the land without the bank's consent.

Mortgages Over Company's Assets (Charges)

A Charge over the assets of a company will normally be similar to those contained in mortgages over real estate. The remedy most employed by banks that hold such securities in the event of default by the borrower is to appoint a receiver or a receiver and manager. A Receiver is normally empowered to take possession of the assets of a company and to sell them for the benefit of the bank. A Receiver and Manager may carry on the business of the company primarily for the benefit of the bank. If this happens, the unsecured creditors and owners may benefit as well. Banks as holders of a charge may also appoint and administrator, normally with a view to a reconstruction of the company’s finances/business.

Charges are usually both fixed and floating. A fixed charge operates over those assets (land, machinery, etc.) which cannot be sold or dealt with without the bank's consent. A floating charge operates over those assets which are normally sold without the consent of the bank because they come and go every day in the ordinary course of business activity e.g. stock and debtors.

A charge usually provides that in the event of a default by the borrower, the floating charge will become fixed, whereby not even the stock can be

sold without the consent of the bank and "the debtors", as collected must go to the bank. This will have the effect of paralysing the business operation and is usually a prelude to the appointment of a receiver whereby the bank can preserve its position over all the assets.

A charge is of course, a form of security for a bank and entitles the bank to be the first to be paid in the event of default, subject to a number of statutory priorities e.g. The Commissioner of Taxation in respect of unpaid Group Tax.

GUARANTEES

Guarantees are contracts between a bank and a third party (the guarantor). The guarantor promises to pay the bank if the customer does not pay. The guarantee may limit the amount for which the guarantor will be responsible or alternatively the liability may be unlimited. The guarantor may be required to give security to the bank, sometimes in the nature of a mortgage over real estate. The mortgage has similar covenants as does a mortgage between a bank and a customer/borrower. Also, the bank has similar rights and powers. The obligations of the guarantor are activated by the default of the customer/ borrower. Once a guarantee has been given it is almost impossible to get out of it because the bank will

normally have assessed its preparedness to lend upon the basis that the additional security of the guarantee was available to it. A guarantor, who is concerned about possible risk such as the diminishing value of the bank's security or the borrower's financial situation, may insist that the borrower pay out the bank. This may involve court action to compel the borrower to sell the security. In other words, guarantees are easy to get into but difficult to get out of and the risk is mostly taken without the prospect of any benefit to the guarantor.

Such a situation arises even in the case of a guarantee given by the directors of a company, particularly companies in which the directors have a proprietary interest. It is most important to understand the exposure in such a situation and to protect oneself accordingly. If the company is placed into liquidation, then the obligations under the guarantee will almost certainly come to life and the bank will call upon the guarantor to pay the debt. If a guarantor does pay, then he/she takes over whatever rights the bank had over the company In this regard the guarantor would be entitled to repayment from the company of the amount which was paid to the bank. If there are other guarantors, then the one who paid is entitled to have the others contribute.

What then can be done to give the guarantor more protection in such

circumstances? A guarantor in those circumstances should insist that the company gives, as security to the bank, a charge over its assets as well. Then in the event of the failure of the company the bank may either appoint a receiver or a receiver and manager to recover their money from the company. This can be achieved either by trading on or by selling the assets. The money so recovered is paid, to the bank to cover its debt before the other creditors of the company are paid. If the bank has to take action against the guarantor, it should only be for any shortfall. If the guarantor pays the bank then the guarantor will be entitled to the same rights against the company as the bank had, including the benefit of the charge. The guarantor has the right to seek reimbursement of the money paid by him or her to the bank by selling the company's assets or trading on.

Banks have tended to prefer real estate mortgages, given by guarantors as they are less complicated and are better understood by the bank's officers. It is in the interests of the guarantor to be aware that the company should give security to the bank as well.

Sometimes a guarantor may be a person not connected to the company, such as a relative or a friend. More often than not guarantors who fall into this category become involved after the bank has made the loan or

provided the facility. They become involved because the bank is uncomfortable with the existing security for some reason or other and has asked the customer to either reduce the debt or to provide more security. The courts have taken the view that it is unreasonable for a bank in these circumstances to involve an outsider to assume some part of the risk. The courts have cast upon banks, that take collateral security in these circumstances, a heavy onus of explaining to the incoming guarantor, the full circumstances of the company and the risk that they run. A failure by the bank to make this complete disclosure may result in a discharge of the guarantor from any obligations under the guarantee. A similar obligation may exist when a guarantee is signed by a person e.g. a wife/director, known by the bank to be a non-active director.