THE CHANGING FACE OF BANKING AND FINANCE: SOME LEGAL IMPLICATIONS

BY ROY GOODE

It is a particular privilege to be invited to deliver the second Falconbridge Lecture here at this distinguished law school, which is soon to celebrate its official centenary.

John Delatre Falconbridge was associated with Osgoode Hall for most of his long life, serving as Dean for no fewer than 24 years. A scholar of international repute, he covered an enormous range. He was the author of major texts on conflict of laws, sale of goods, mortgages of land, business law, negotiable instruments and banking and bills of exchange, the last of which has recently been republished in a superb new edition — indeed, it is a new book — by

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I should like to acknowledge my thanks to Mr. Thomas E. Cimeno Jr. and Mr. Paul M. Connoly, Senior Vice Presidents of the Federal Reserve Bank of Boston for the very helpful information and documents they supplied: to the Deans, law librarians and staff of the University of Texas, Austin, Boston University, Harvard, Osgoode Hall and the University of Toronto for making their facilities available and for all their help in the literature searches which preceded the preparation of this lecture; to Messrs. Borden & Elliot, Toronto, for generously supplying me with a copy of the Estey Report on the Collapse of the CCB and Northland Bank; to Professor Hal Scott of the Harvard Law School for kindly giving me a copy of the Report referred to at note 35 below; to Mr. Gordon Sedgwick, Q.C. for supplying me with a copy of his paper referred to at note 40 below and other material; and to the many other acquaintances, friends and colleagues who were so generous with their time in accommodating my propensity for asking endless questions.
Mr. Bradley Crawford.\textsuperscript{1} Dean Falconbridge, a retiring man of whom virtually no anecdotes survive, by his example laid the foundation for what was to become a power-house of legal scholarship. It is fitting that his memory should be kept alive in this annual lecture in his honour.

What I shall seek to do in the time allotted me is to identify some of the principal characteristics of modern banking; to discuss the legal implications of evolving banking practice; and to indicate how academic commercial lawyers might both give and receive intellectual benefit from a study of developments in banking.

I. SOME PRINCIPAL FEATURES OF MODERN BANKING

The last decade has witnessed a revolution in the provision of banking services and in their regulation. We can identify at least seven major developments.

A. The Opening up of Access to the Financial Markets

In the major financial centres of the world, the barriers to entry into the financial markets are being steadily dismantled. This movement towards increased competition has both an internal and an external aspect. Internally it is reflected in the admission to the market of non-banking financiers and financial intermediaries. Externally, it manifests itself in the growing willingness to allow foreign banks to compete with the home banks.

B. Deregulation and the Reduced Significance of Banking Status

An equally strong characteristic of modern banking is the movement towards deregulation of financial services and the replacement of statutory controls by administrative supervision. The thrust for deregulation comes from the desire of governments to

\textsuperscript{1} B. Crawford & J.D. Falconbridge, \textit{Banking and Bills of Exchange}, 8th ed. (Aurora, Ont.: Canada Law Book, 1986).
promote competition and, at the international level, to attract foreign business. Since effective competition is impaired if some institutions are subject to rules that do not affect others, an aspect of deregulation has been the removal of restrictions on activities in which certain types of institution, such as banks and building societies, are permitted to engage, and a movement away from specialist financial organizations towards financial conglomerates offering a wide package of services. The result is that banking status, which traditionally has conferred various privileges such as the right to designate oneself a banker, to accept deposits and to maintain hidden reserves, is becoming of reduced importance. It is significant that the United Kingdom *Banking Act 1987* makes few references to banks except in its short title; the statutory provisions now refer to "authorised institutions," that is, institutions authorized by the Bank of England to accept deposits.

C. Disintermediation

This hideous term, typical of the inelegance of modern jargon, denotes a change in the role of banks from that of principal in the money markets, borrowing from depositors and lending to investors, to that of financial intermediary. This change has come about through competitive forces. Borrowers discovered that they could obtain funds more cheaply by borrowing direct from the commercial sector; lenders, that they could obtain a greater return on funds by lending direct to the market. Banks have thus shifted their emphasis from direct lending to underwriting, broking and packaging of deals for lenders and borrowers.

D. Securitization

Hand in hand with disintermediation goes securitization, a process by which lenders package their financial assets and convert them into marketable securities which are then issued either direct
to the market or by placement.\(^2\) Securitization has been fuelled by the change in the role of the banks, the desire to increase liquidity by unloading medium- and long-term loans on to the market and the wish to reduce assets so as to avoid having to increase capital consequent upon the requirements of the regulatory authorities as to capital-assets ratios.\(^3\)

E. Globalization of the Markets

A particular feature of modern finance is the interdependence of the world's financial centres, the rapid movement of funds from one centre to another and the development of Eurosecurities as instruments largely beyond the purview of national regulatory systems.

F. Convergence of the Financial and Securities Markets

The securitization of financial assets has blurred the distinction between the financial market and the securities market. This convergence of the markets is becoming reflected in their respective clearing systems, for both are moving sharply away from paper-based transfers\(^4\) and the electronic settlement of obligations arising from dealings in securities is becoming increasingly integrated with electronic funds transfer.


\(^3\) For a description of the development and methods of securitization, see *Recent Innovations in International Banking*, a Report of the Study Group established by the Central Banks of the Group of Ten Countries (Bank for International Settlements, April 1986).

\(^4\) See below.
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G. The Advent of New Technology

The movement away from paper initiated by the banks in the transfer and clearing of funds is now gathering momentum in relation to securities dealings with the development of book entry systems of transfer. These are designed to dispense with transfer instruments and to avoid the necessity for registration of changes of ownership in the books of the issuing company where this results from dealings between system participants.

II. THE IMPACT OF CHANGES IN BANKING PRACTICE

Where is all this leading to and what are the implications for law and lawyers? There are, as it seems to me, at least three consequences of the developments described above.

Firstly, we can see increased tensions between competing objectives: competition and financial stability; competitive efficiency and the maintenance of ethical standards; the advantages of scale and the limiting of risk; the integration of financial services and the regulation of conflicts of interest; the need for speed and the need for care in the giving of advice and the preparation of documents. An aspect of these tensions is the Janus-like approach of governments to the role of the law in financial and securities dealings. On the one hand, we have the move towards deregulation, the freeing of financial institutions from many of the legal shackles of the past in order to promote competition and keep down costs. On the other hand, we have a recognition that standards of behaviour in the market are not what they should be and that the removal of barriers to access to the market will bring in players who are not of the old school and who are more aggressive in their marketing and less sensitive to ethical considerations than the blue-blooded banking aristocracy; and that for these new players fresh rules have to be devised which previously were considered unnecessary.

Secondly, we are having to come to terms with the fact that volatility of the markets is no longer the inevitable harbinger of doom but is a fact of everyday life. This is a consequence of the growth of huge conglomerates, the interdependence of the financial
centres and of the ability of corporate treasurers, through modern technology, to shift vast funds at the press of a button from one centre to another to attract the highest return and avoid the restrictions on hours of trading.

Thirdly, this volatility means that hanging over the financial world is the threat of massive bank failures. The volume of funds now capable of being processed in one of the major financial centres is huge. The daylight exposure of a major bank pending end-of-day settlement can amount to as much as eight or nine times its capital. Investors and depositors have a touching faith in the assurance of government support to prevent the failure of a major bank, but such support can be expensive and its continuance by no means inevitable. A striking example is to be found in the collapse of two Alberta banks, the Canadian Commercial Bank and the Northland Bank, which together received support from the Bank of Canada to the tune of nearly $2 billion but ultimately went into liquidation when the Bank of Canada and the commercial banks decided that a further infusion of funds was not justified. A striking example is to be found in the collapse of two Alberta banks, the Canadian Commercial Bank and the Northland Bank, which together received support from the Bank of Canada to the tune of nearly $2 billion but ultimately went into liquidation when the Bank of Canada and the commercial banks decided that a further infusion of funds was not justified. Concern for the financial soundness of banks has become a major preoccupation of central bankers, and vigorous attempts are being made not only to tighten banking supervision and ensure the adequacy of capital resources maintained by banks but to achieve increased harmonization of capital adequacy standards. To that end the central bank governors of the Group of Ten have endorsed the far-reaching proposals of the Basle Committee on Banking Regulation and Supervisory Practices (otherwise known as the Cooke Committee) for the convergence of national standards, while the European Community (EC) Commission has presented a proposal.

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5 For a detailed description of the rise and fall of the two banks see *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Minister of Supply and Services: Canada, 1986) by Mr. Justice Estey, who concluded (at 347) that the banks' problems resulted not from inherent lack of required qualities in the administrators but in the inadequacies of the structure of the regulatory establishment.

for a Second Banking Coordination Directive\textsuperscript{7} and recommendations on the monitoring and control of large exposures of credit institutions\textsuperscript{8} and the introduction of deposit-guarantee schemes in the Community.\textsuperscript{9}

It is against the background of the potential failure of one or more major players in the market that I propose to examine some of the issues of public law and private law that are likely to arise in the new financial era. In deference to the Socratic style so popular in North America I shall pose the questions rather than attempt to answer them.

III. ISSUES OF PUBLIC LAW

A. The Implications of Deregulation

With deregulation comes the need for greater supervision. Statutory rules carrying penal sanctions are replaced by membership rules devised or approved by the regulatory authorities and enforced by reprimand or by suspension or forfeiture of licence or membership, with the consequent inability to trade in the market. Activity is controlled less by legal requirements and restrictions than by the exercise of administrative discretion in the formulation, interpretation and enforcement of the rules of the game.

The efficiency of such a system varies inversely with the length and complexity of its rule books. International financial centres live by the service they offer the financial community, which requires speed, simplicity, accuracy and reliability in the transacting of business and the settlement of obligations. Self-regulation is most easily achieved when the market is homogeneous and the players are few and select. In such a milieu formal rules can largely be dispensed with. One of the more striking features of British


\textsuperscript{8} 87/62/EEC 22 Dec. 1986 (O.J. 4.2.87).

\textsuperscript{9} 87/63/EEC 22 Dec. 1986 (O.J. 4.2.87).
banking, astonishing to foreigners, was that for over 130 years it operated with virtually no controlling legislation of any kind whatever. Apart from exchange controls, later abolished, everything was achieved by moral suasion; a polite letter from the Governor of the Bank of England to the clearing banks indicating, for example, that a reduction in the extension of consumer credit would be appreciated was all that was needed, for no banker in his or her right mind would buck the Bank of England.

Now, all that has changed, and though some would mourn the passing of such a golden era, it was inevitable. For of course the corollary of such a closed system is that although it facilitates the maintenance of high standards of integrity and business behaviour, it is also anti-competitive and relatively impervious to change. The encouragement of competition, so necessary to healthy economic growth, has also led to a breakup of the cohesion of the banking industry, which now encompasses so wide a range of business activity and such a disparate membership that we can no longer say what we mean by a bank or by banking. The result, inevitably, is a decline in ethical standards as the brash, confident newcomers gradually come in to displace the traditional banker, with little patience for the professional rules in which that banker was nurtured; and with this comes the perceived need for control of access to the markets, for more detailed rules, more closely regulated procedures, so that paradoxically the main advantages of deregulation, namely competition, freedom and flexibility, become whittled away by an ever growing rule book designed to cater for those who regard themselves as bound not by the spirit of the rules but only by the letter.

B. The Deposit-takers

And this is where one of the first issues of public law begins to surface. What institutions should be allowed to take deposits? The primary concern here, of course, is the soundness and integrity of the depositary institution. In regulatory folklore this was best achieved by confinement of the deposit-taking power to specialized institutions. Thus, in England a company which expanded its activities significantly beyond those traditionally associated with
banking, for example by substantial investment in non-banking subsidiaries, was liable to meet with a refusal of its application to be accorded banking status so as to entitle it to advertise for deposits; in the United States the Banking Act 1933\textsuperscript{10} sought to separate investment banking from commercial banking by prohibiting national banks from underwriting securities and investment banks from accepting deposits, whilst the Bank Holding Act conferred on the Federal Reserve Board power to restrict the ownership of banks by securities firms, an irksome restriction which led to avoidance through the phenomenon of the non-bank bank;\textsuperscript{11} and in Canada the federal Bank Act restricts the ability of banks to engage in trade and underwrite securities, whether directly or through a non-banking subsidiary.\textsuperscript{12} But times are changing, and with the pressure on banks to increase profitability and find new sources of income, and on financial centres to attract business and promote competition, the legislatures are beginning to relax the old rules so as to allow institutions of different kinds to compete on an equal footing. We are now witnessing a movement away from restrictions on the types of business in which a bank can engage towards a regime which concentrates on the prudential management of the affairs of deposit-taking institutions.

Concern for security necessarily means that a wide discretion has to be conferred on the regulators to grant or refuse authorization to accept deposits. The legislative provisions or administrative rules may themselves embody a right of appeal against refusal of authorization; but where no such right is given or where an appeal is unsuccessful we can increasingly expect challenges by disappointed parties by way of application for judicial review.\textsuperscript{13} The

\textsuperscript{10} § 89, 48 Stat. 162 (1933), ss. 16, 20, 21, 23. This part of the Banking Act is popularly known as the Glass-Steagall Act.

\textsuperscript{11} These developments are well described by Golembe and Holland, Federal Regulation of Banking 1986-87 (Washington, D.C.: Golembe Associates Inc., 1986) c. 4, 10.

\textsuperscript{12} Bank Act, S.C. 1980, c. 40, ss. 174, 190, 193. For a detailed analysis, see Crawford & Falconbridge, supra, note 1 at c. 13, 16.

\textsuperscript{13} In England, it has recently been held that the Takeover Panel, though not a statutory body but a mere unincorporated association entirely devoid of legal personality and of common law or prerogative powers, is nevertheless susceptible to judicial review since it exercises important public law functions and duties and wields great power: R. v. Panel on
question also arises whether a remedy in damages is available in private law based on the tort of negligence or breach of statutory duty, and if not, whether public law in common law jurisdictions will develop to the point of enabling the courts to entertain claims for compensation by applicants who have suffered loss through refusal of authorization, where the regulatory authority has breached the rules of natural justice or has acted wholly unreasonably or in a manner inconsistent with the principles and rules it is charged to apply.\\(^{14}\)

C. Protection of Depositors

The perceived importance of maintaining confidence in the integrity of the banking system has led in most countries to special measures for the protection of bank depositors.\\(^{15}\) Typically these take one of two forms: a special priority for depositors vis-a-vis other unsecured creditors in the winding up of the bank, and State-regulated deposit insurance. Full insurance cover for a depositor is open to the objection that it enables him or her to bank with the institution offering the highest deposit rates without assuming any of the attendant risks. Hence the United Kingdom Banking Act limits the amount of a depositor’s claim against the Deposit Protection Fund to three-quarters of his protected deposit.\\(^{16}\)

\[\textit{Take-overs and Mergers, ex parte Datafin plc, [1987] 1 All E.R. 564.}\]

\(^{14}\) The prospects of a successful claim in England are not auspicious. The conventional view, recently affirmed by the Court of Appeal in \textit{Jones v. Department of Employment}, [1988] 1 All E.R. 725, is that where the statute prescribes a procedure for appeal against an administrative decision, the party concerned has no remedy in private law, only a remedy in public law; and that the latter is limited to the prescribed procedure or judicial review. There is now a sharp movement away from \textit{Annis v. Merton London Borough}, [1978] A.C. 728 and a growing reluctance to hold that public bodies or officers owe a duty of care actionable in tort. See the recent decision of the Privy Council in \textit{Rowling v. Takaro Properties Ltd.}, [1988] 1 All E.R. 163. Where judicial review is available, a claim for negligence would in any event be limited to loss not avoided by the review; that is, loss resulting from the delay elapsing between the time of the order complained of and the time it is quashed by the court.

\(^{15}\) The vexed question what is a deposit receives no fewer than five pages of analysis in \textit{Crawford & Falconbridge, supra}, note 1 at 757-61.

\(^{16}\) \textit{Banking Act 1987} (U.K.), 1987, c. 22, s. 58(1). By "protected deposit" is meant the depository institution’s liability to the depositor up to a maximum of £20,000 (s.60(1)).
Do the regulatory authorities owe any legal duty to existing or prospective depositors? Could a depositor or other creditor of a bank which failed assert a claim against the authorities for negligence in granting an authorization which ought not to have been granted or in failing to exercise due care and diligence in the execution of their supervisory functions? Such a claim could conceivably be founded either on the tort of negligence or on breach of statutory duty, though the courts are unlikely to view it with enthusiasm, particularly where the relevant legislation prescribes an appeal procedure.

D. Protection of Other Investors

The development of financial conglomerates and the expansion of financial services have brought in their train a perceived need for regulation in the interests of investors going far beyond deposit protection. The U.K. Financial Services Act 1986 provides a complex structure of self-regulation of the securities industry within a statutory framework. The principal regulator is the Securities and Investments Board (SIB), which operates under rules approved by and powers delegated by the Secretary of State. SIB in turn is responsible for exercising general control over the various self-regulating organizations (SROs) and approving their rules. No one will be allowed to carry on regulated investment activities. Which currently in England is somewhat on the retreat, with a distinctly cooler judicial attitude to cases such as Anns v. Merton London Borough Council, [1978] A.C. 728 and Junior Books Co. Ltd. v. Veitchi Co., [1983] A.C. 520. See, for example, Muirhead v. Industrial Bank Specialities Ltd., [1986] Q.B. 507; Yuen Kun-yeu v. Attorney-General of Hong Kong [1987] 2 All E.R. 705.


18 See Yuen Kun-yeu v. Attorney-General of Hong Kong, ibid., where the Privy Council upheld decisions of the Hong Kong High Court and Court of Appeal striking out a claim for negligence against the Commissioner of Deposit-taking Companies as disclosing no cause of action. See also the cases referred to at note 14, supra.

19 See supra, note 14.

20 This covers dealing in investments, arranging deals in investments, managing investments, advising on investments and establishing, operating or winding up collective investment schemes (Financial Services Act 1986 (U.K.), 1986, c. 60, s. 1(2) and Sch. 1, Part II).
unless authorized or exempt.\textsuperscript{21} Authorization, where not automatic,\textsuperscript{22} is obtained by membership of an SRO, by membership of and certification by a recognized professional body or by direct authorization from SIB. The \textit{Act} contains various rules designed to ensure the proper conduct of investment business and these are buttressed by a mass of rules from SIB\textsuperscript{23} and the SROs which threaten to engulf the securities industry in a tidal wave of regulatory detail which will inevitably involve substantial expense and some loss of efficiency. A separate statute prohibits insider dealing.\textsuperscript{24} Various civil remedies are given to investors, in addition to which SIB is given power to apply for injunctions and restitution orders. All this makes a field day for lawyers, and can be expected (\textit{inter alia}) to accelerate still further the growth of administrative law in the banking field.

IV. ISSUES OF PRIVATE LAW

The evolution of new and constantly changing financial instruments and mechanisms provides a rich fare for the academic lawyer who wishes to sharpen his or her perception of basic concepts of contract and property law. Many of these centre on the impact of a party's insolvency, which is the point at which the distinction between proprietary and personal rights is likely to become significant.

There are three sets of issues in the sphere of private law to which I should like to direct your attention, namely the characterization of a transaction involving the sale of financial assets,

\textsuperscript{21} Ibid., s. 3.

\textsuperscript{22} For example, for authorized insurers and for "Euro-persons."

\textsuperscript{23} Among which are the restriction of claims to offer independent services, a prohibition on excessive charging and "churning" (changing a client's investments with excessive frequency to earn commission), a "know your customer" rule, a "suitability" (of a particular transaction for the particular customer) rule, a written customer agreement, a best advice and best execution requirement, a restriction on self-dealing and a requirement for the disclosure of material interests and commissions. See Rider, Chalkin & Abrams, \textit{Guide to the Financial Services Act 1986} (Bicester, Eng.: CCH Editions, 1987) c. 6.

the legal impact of clearing systems, and the liability of banks on the insolvency of their non-banking subsidiaries.

A. Characterization of Agreements

I will select by way of illustration two forms of financing, the sub-participation and the sale and repurchase of securities. The former is widespread; the latter, known in the vernacular as a repo, has developed strongly in recent years in the United States. In each case the question arises whether the transaction confers on the buyer a proprietary right over an asset of the seller or merely a personal right against the seller. Sub-participations and repos provide yet another example of how important it is for the practising lawyer to have a thorough understanding of fundamental legal concepts, which surface again and again with the development of new financing techniques, and which in the process of re-examination become more refined and sophisticated.

B. Sub-participation

There are three principal ways in which a lead bank or other seller can unload financial assets, namely assignment (sale of the asset to the buyer), novation (buyer becomes the creditor in place of seller) and sub-participation. In a funded sub-participation the buyer (sub-participant) agrees to deposit with the seller (original lender) a sum of money representing an agreed proportion of the amount advanced or to be advanced by the seller to the borrower, the buyer acquiring in exchange a right to receive from the seller a sum equal to the same proportion of the amount repaid by the borrower.

The question I wish to consider is the effect of the insolvency of the seller on the buyer (a) as to money received from

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25 For brevity the term seller will be used to denote the party who confers or transfers rights related to a financial asset owned by it and the term buyer will be used to denote the party who makes a payment to the seller to acquire those rights.

26 As opposed to a sub-participation in the form of a guarantee, which I shall not discuss.
the borrower for which no payment has been made to the buyer, and (b) as to money payable by the borrower to the seller but not yet paid. The answer to this question depends on the nature of the agreement between seller and buyer. There are at least four possible ways of characterizing the transaction. Firstly, it may be treated as an outright assignment (sale) of the seller's rights against the borrower. Secondly, it may be categorized as a sub-loan (or back-to-back loan) by the buyer to the seller on the security of the receivable held by the seller. Both these forms of agreement confer on the buyer a proprietary interest in the loan asset and thus give the buyer direct rights against the borrower, whether directly or through the seller. Thirdly, it may be an unsecured sub-loan by the buyer to the seller to be repaid only when and to the extent that the seller receives payment of the loan from the borrower, the buyer having no rights over the loan asset and no relationship with the borrower. Finally, it may be the "purchase" by the buyer of a right against the seller to payment of a sum of money measured by reference to the sum received by the seller from the borrower.

Prima facie a sub-participation falls into the last category. The lead bank as seller usually makes great efforts to exclude any relationship between buyer and borrower and any proprietary interest of the borrower in the loan asset. So, typically the buyer neither purchases the asset nor lends against a mortgage or charge of the asset. Nor will the transaction normally constitute a sub-loan by buyer to seller. This is because the sum which the buyer is entitled to receive in the usual sub-participation is measured not by the amount it deposits with the seller but by a due proportion of the amount the seller receives from the borrower. In other words, the buyer's entitlement is not to repayment of its deposit with interest but to payment of a sum equal to a due proportion of the amount repaid by the borrower to the seller. The buyer thus pays its deposit to obtain a claim on the seller for a sum equal to \( x \) per cent of the seller's receipts. The buyer has no interest in the

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27 It is customary to speak of the sale of a participation but this term is used in a commercial, not a legal sense, and though capable of indicating an assignment of the seller's rights against the borrower, could (and usually does) refer to the conferment on the buyer only of rights against the seller.

28 Depending on whether the assignment is legal (statutory) or equitable.
receipts themselves; they merely provide the measure of its claim on the seller.

Where does this leave the buyer? It has a double credit risk: insolvency of the borrower and insolvency of the seller. It can safeguard itself by requiring the seller (if the latter is willing) to make a declaration of trust in favour of the buyer. Several points arise in connection with this. Firstly, there has to be an intention to create a trust. Secondly, a trust requires an identified subject-matter. If the seller collects payment by way of set-off and becomes bankrupt without passing on a due proportion, the buyer cannot assert a trust, for there is no res to which this can attach. Thirdly, there must be a duty on the seller to segregate receipts from the borrower as an identified trust fund. There can be no trust if the seller is permitted to treat the receipts as its own and mingle them with its other moneys. Finally, if a trust is established, it is a question of construction whether this is limited to sums actually received from the borrower (in which case any unpaid part of the debt vests in the seller’s trustee) or whether it extends to the unpaid debt itself. As an alternative to a trust established by the seller, which has sometimes been held to exist, the seller may transfer the assets to a separate subsidiary to hold on trust for sub-participants. The question then is whether the transfer and ensuing trust can withstand a claim to pierce the corporate veil and treat the assets as still those of the seller. These issues deserve further study by both academic and practising lawyers.

31 For an example, see Re Canadian Commercial Bank, [1986] 5 W.W.R. 531.
C. Sale and Repurchase (Repo)

In the typical repo operation a party holding a portfolio of securities sells an undivided interest in the portfolio to another and simultaneously agrees to repurchase the securities, or to buy an equivalent amount of similar securities, at a premium at a later date. The repurchase price is fixed, and thus does not depend on the value of the securities at the time of repurchase; and the repo may be rolled over for successive periods, which can be as short as a day. A proliferation of transfer and retransfer documents is avoided by use of the book-entry system for repo securities, and special rules govern the transfer of title and the perfection of security interests. Is the sale and repurchase what it purports to be or is it a thinly disguised secured loan? If the latter, does the "purchaser" acquire an effective security interest and how is this to be perfected? Again, it is the insolvency of the seller which makes the problem more than academic, for if the transaction is a secured transaction it will be invalid against the seller's bankruptcy trustee unless duly perfected.

D. The Legal Impact of Clearing Systems

Most substantial funds transfers are effected either through a bank clearing or by a series of bilateral debits and credits in the

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33 For a more detailed description and discussions of the legal problems, see W. F. Hagerty IV, "Lifting the Cloud of Uncertainty Over the Repo Market: Characterisation of Repos as Separate Purchases and Sales of Securities" (1985) 37 Vand. L.R. 401 and literature there cited.

34 See Uniform Commercial Code [hereinafter U.C.C.] s. 8-313 (which deals with title transfers) and Federal Treasury regulations (which deal with the grant of security interests in U.S. government book-entry securities and partially displace Art. 9 of the U.C.C.), and see below. The extent to which the seller's acquisition of a proprietary interest in the securities depends on their identification varies according to the legal system applicable to the transaction. In America an agreement to transfer a given quantity of securities forming an undivided part of a fungible bulk is effective to give the buyer a proportionate interest in the bulk (U.C.C. s. 8-313(1)(d) and Official Comment, para. 5). In England this would not suffice; the seller would have to transfer a part interest in the bulk, and if he merely purported to transfer an unsegregated quantity of securities forming part of the fungible bulk he would be an unsecured creditor.
accounts of the transferor and transferee banks with the central bank. I have earlier drawn attention to the magnitude of the daylight exposure of clearing banks in major financial centres, resulting from the capacity of electronic systems to process vast numbers of transactions very rapidly, so that a bank may find that the value of payment instructions it has implemented during business hours greatly exceeds the value of its receipts during the same period. This is a problem of growing concern to central bankers. In America, funds transfer overdrafts are controlled by bilateral limits and caps, and consideration is now being given to the problem of the book-entry overdraft which results from a bank's same-day settlement obligations for buyers exceeding the value of securities it transfers for same-day settlement by other banks.35 On both sides of the Atlantic the authorities have addressed themselves to the possible impact of a bank or systems failure and to the legal effectiveness of purchase-money security interests taken by custodians and clearing agents to secure recoupment of outlays for which they commit themselves on behalf of customers.36 Book-entry transfers generate both payment and delivery exposure. The seller and its bank are exposed to the risk of non-payment, the buyer and its bank to the risk of non-delivery of the securities after payment has been made. The book-entry system is so constructed that transfer and payment are required to be simultaneous. However, the selling bank is exposed to the risk of non-delivery as regards transfer messages it sends on behalf of a selling customer before it has taken delivery of the seller's security, whilst the buyer banker is exposed to the risk of non-payment as regards payment messages by which it commits itself to the seller bank in advance of being put in funds by its customer. In the former case, the requisite amount of securities has to be obtained to cover the delivery obligation and in

35 For a detailed discussion of the problem and alternative solutions, see the Report of the Working Group of the Association of Reserve City Bankers on Book-Entry Daylight Overdrafts (Association of Reserve City Bankers, June 1986).

36 In America such security interests are regulated partly by the Federal Treasury regulations and partly by Art. 9 of the U.C.C. In the United Kingdom a settlement bank's exposure in the Central Gilts Office System is typically covered by a floating charge taken by the bank over the government securities it receives for its customer and over its customer's receivables in respect of subsequent resales of securities.
the latter the bank has to advance the money on behalf of its customer. The dealers operate on funds borrowed from the banks who in turn incur intra-day overdrafts to the central bank which are required to be zeroed by the end of the day. Dealers also cover their delivery obligations by borrowing securities or by buying them on repo terms (reverse repo).

The importance of clearing systems and system rules in determining the legal rights of the various participants is only now coming to be appreciated by academic and practising lawyers. The advent of electronic clearing and transfer systems raises a host of difficult questions which have yet to be resolved by the courts. At what point does a payment message become irrevocable? When and where does an actual transfer of funds take place? In a chain of dealings in book-entry securities, who owns what at any particular stage? And who carries the risk of failure of a participant? These are questions to which banks would do well to address themselves and to provide solutions, by way of contract if they can, for otherwise the legislature or the courts will have to do it for them and they will not necessarily like the results.

E. Legal Liability of a Bank for Its Non-banking Subsidiaries

The final topic in the field of private law to which I should like to refer is the possible legal liability of a bank for the debts and

37 A pioneer in the field is Professor Hal Scott, who devised a comprehensive New Payments Code, an ambitious and scholarly text designed to cover all payment systems and to replace Arts. 3 and 4 of the U.C.C.. (See H.S. Scott, "Corporate Wire Transfers and the Uniform Payments Code," (1983) 83 Colum. L. Rev. 1664.) This project met with hostility from the banking community and has been abandoned in favour of a more modest Art. 4A restricted to payment by wire transfer. For an up-to-date description and details of other relevant literature, see B. Geva, "The Evolving Law of Payment by Wire Transfer -- An Outsider's View of Draft UCC Article 4A" (Address to the Seventeenth Annual Workshop on Commercial and Consumer Law at the University of Toronto, October 1987) (1988) 14 C.B.L.J. 186.

defaults of its non-banking subsidiaries. The subject of lenders' liability is assuming growing importance. The American Practising Law Institute has devoted a complete handbook to the subject and Mr. Gordon Sedgwick has identified no fewer than a dozen possible causes of action against a bank in a list which does not claim to be exhaustive.

My concern is with one particular aspect only: the possible liability of a bank when one of its non-banking subsidiaries fails.

Received wisdom is, of course, that the question is of theoretical interest only, since no bank would risk its reputation by disclaiming responsibility for its failed subsidiary's obligations. However, in the present-day world a parent's voluntary assumption of the burden of discharging its subsidiary's obligations can no longer be taken for granted. Indeed, unless such action were genuinely and reasonably perceived as being in the interests of the parent its directors would be guilty of breach of duty in applying shareholders' funds to the discharge of the obligations of what in law is a separate legal entity for whose debts the parent is not responsible. In the United Kingdom the principle of Salomon v. Salomon retains its full vigour and the courts remain reluctant to pierce the corporate veil. The parent bank may, however, be at greater risk from a different source of liability, namely that imposed on directors and shadow directors for participation in wrongful trading. A parent bank which intervenes too closely in the management of its subsidiary may find itself labelled a de facto director or a shadow director so as to attract potential liability for wrongful trading, with a concomitant obligation to make such contribution to the subsidiary's

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39 Lender Liability Litigation: Recent Developments (New York: Practising Law Institute, 1987).

40 G. Sedgwick Q.C., "Lender Liability: Protection and Precautions for Lenders" (Address to a conference on lenders' liability, Toronto, November 1987) [unpublished].

41 A shadow director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him [or her] in a professional capacity)" (Insolvency Act 1986 (U.K.), 1986, c. 45, s. 251).

42 Ibid., s. 214.
assets on winding up as the court thinks proper.\textsuperscript{43} Where the subsidiary is run entirely for the benefit of the parent and its \textit{de jure} directors are directors of the parent or mere puppets of the parent board, the parent bank may be susceptible to claims on the basis that the subsidiary is its agent or is a mere instrumentality for implementing the parent's will.\textsuperscript{44} These issues are not, of course, peculiar to banks, but may be expected to surface more frequently in the field of banking as banks move into other areas of business and finance their non-banking subsidiaries.

V. CONCLUSIONS

The new banking regimes and instruments pose a range of difficult legal issues of public and private law which have hitherto been inadequately explored. I have endeavoured to depict some of the more important of these, and if I have succeeded in provoking some interest in the subject by those who have not previously had occasion to think about it I am content.

In thanking you once again for the honour you have done me in inviting me to deliver this, the second Falconbridge Lecture, I must express my admiration of your attentiveness during the past hour despite the fact that a luncheon awaits from which I must keep you no more than a moment longer.

In such debates and analyses as have been generated, most of the running has until recently been made by the practitioners, and with a few honourable exceptions academic commercial lawyers have tended to keep out of the field, whether from ignorance, lack of curiosity or an understandable fear of the legal complexities. But academics have much both to learn and to contribute in this as in other fields of law. The raw material with which practitioners work to solve specific problems for particular clients can be fashioned by law teacher for their own purposes in teaching and research, for it enables them to see the role of established principles in an

\textsuperscript{43} \textit{Ibid.} s. 214(1).

\textsuperscript{44} Such claims are more likely to meet with success in the United States, which now has a substantial body of jurisprudence on these issues, than in England, where the case law remains sparse.
unfamiliar setting and thereby strengthens their understanding of them and their ability to impart to their students theoretical concepts in the context of contemporary practices and problems. Working together in fruitful collaboration law teachers and practitioners can help each another, each group drawing on the other's expertise to enrich its knowledge of its own field. As a scholar of international standing, keenly interested in business practice and responsible over many years for what was then a professional law school, Dean Falconbridge would surely have approved.