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Insolvent Bank’s Irrevocable Credit as Priority Payment Instrument: Barclays Bank v. Price Waterhouse

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On the insolvency of a member of the Canadian Payments Association, unpaid cheques certified by the insolvent member, followed by its unpaid “priority payment instruments”, are accorded priority over other unsecured claims against its estate. Generally speaking, a member is a regulated depository financial institution, such as a bank, trust company, or credit union. “Priority payment instrument” is defined to mean “a money order, bank draft or similar instrument” issued by a member other than in payment to another member. Priority is conferred on the payment of certified cheques and priority payment instruments only for the unpaid balance after recovery from available deposit insurance, and to the extent that a request for payment is made within sixty days after the receiving or winding-up order is made against the insolvent member.

It was held in Canada Deposit Insurance Corp. v. Canadian Commercial Bank\(^2\) (“CCB”) that claims under irrevocable letters of credit issued by the insolvent institution prior to the commencement of its liquidation are “priority payment instruments”:


> *352 Although a Letter of Credit is not prima facie a priority payment instrument … once a beneficiary has made a demand for payment in strict compliance with the terms of the Letter of Credit, the letter together with the demand constitute a draft which, once accepted, becomes an accepted bill of exchange equivalent to the instruments specifically mentioned in [section 21(1)], so as to come within the meaning of “or similar instrument”.\(^3\)

In response to this judgment this author expressed a contrary view.\(^4\) Nevertheless, CCB was recently followed in Canada Deposit Insurance Corp. v. Canadian Commercial Bank (“Barclays Bank”).\(^5\) Speaking for the Alberta Court of Appeal, Berger J.A. re-examined and refined the statutory interpretation. Particularly on policy grounds, he cited with approval\(^6\) Crawford’s position\(^7\).
The purpose of this note is to re-examine the issue and re-state the criticism on the CCB judgment as followed in Barclays Bank. Accordingly, I re-submit that neither a letter of credit nor an accepted bill of exchange is a “similar instrument” to a money order or a bank draft so as to constitute a “priority payment instrument” under the Canadian Payments Association Act. Implementing any policy of according priority to certain letter of credit claims is a matter of legislative intervention and not of the statutory interpretation of the provision under the Canadian Payments Association Act.

Indeed, bank drafts and bank money orders are instruments on which the issuing depository financial institution is liable. As such, they are undoubtedly not all that different from the irrevocable letter of credit or the accepted bill of exchange. Nonetheless, liability by the issuing institution is not the sole common feature of the bank draft and the bank money order. Both instruments, as well as the certification of a cheque, are cash payment machineries for the transmission of funds from debtors to creditors. Besides giving the creditor the assurance of payment in the form of the issuing or certifying institution’s obligation on them, bank drafts and bank money orders facilitate the avoidance of the risk of physical carriage of money. On their issuance (or certification), either the issuing (or certifying) institution debits the account of the party using the instrument in payment, or that paying party delivers cash to the issuing institution. In contrast, both the letter of credit and the accepted bill of exchange are credit facilities or instruments whose issuance (or acceptance) is not accompanied by cash payments or its equivalent to the issuing institution; as such, they are not “similar” to the bank draft or the bank money order.

Limiting the category of “priority payment instruments” to true payment, rather than credit, instruments is consistent with the name given to the category (“priority payment instruments”) as well as with the title of the statute that provides for the priority of these instruments (“the Canadian Payments Association Act”). To some extent, the limitation of priority to a sum not recovered from deposit insurance also lends support to the conclusion that only instruments of the type drawn on insured deposits qualify as “priority payment instruments”. Indeed, certified cheques and priority payment instruments are accorded priority even where they are not drawn on insured funds. Nevertheless, it can strongly be argued that the insurability of deposits on which instruments of this kind may be drawn is a common denominator linking all instruments falling within the category. Neither the letter of credit nor drafts drawn thereunder qualify.

Moreover, a money order, explicitly stated to be a “priority payment instrument,” need not be a “bank money order” signed by the issuing bank; it could also encompass the “personal money order” sold by the issuing institution over the counter, against funds received from the paying party and segregated for payment, but without the explicit obligation of the issuing institution attached to it. To the extent that the issuing institution is not liable on a personal money order, and assuming that “money order” includes a personal money order, the issuing institution’s liability on the issued instrument is accordingly not even a common feature of instruments that constitute “priority payment instruments” under the Canadian Payments Association Act. Obviously, the validity of this interpretation supposes that the statutory requirements under which a priority payment instrument must be “issued” by a depository institution does
not mean that such an instrument must be “signed” by that institution. Rather, it is enough that such an institution will sell the instrument over the counter. Perhaps this interpretation is satisfied by the requirement under section 31(1) of the Canadian Payments Association Act that a priority payment instrument must be issued “directly or indirectly” by a depository institution. Stated otherwise, an instrument sold over the counter and not signed by the institution such as, arguably, the personal money order, is issued by the institution “indirectly”.

9 For the personal money order, see Geva, ibid. at 130 145.

10 For this question, see Geva, ibid.

11 Cf. definition under s. 2 of the Bills of Exchange Act, R.S.C. 1985, C. B 4, under which “issue” means the first delivery of a complete instrument to a holder, which does not necessarily trigger liability of the issuer without the issuer’s signature (s. 130 of the Bills of Exchange Act). While without the signature of a party liable on the instrument there is no complete instrument (s. 16(1)), such a party liable need not necessarily be the issuer.

In fact, the feature that is common to the bank draft and the money order is the setting aside by the issuing institution of the paying party's funds, in anticipation of payment to the holder presenting the instrument. The “priority payment instrument” mechanism effectively stamps funds, paid by the paying party to the issuing institution before the latter's insolvency, with trust, in favour of the one entitled to the instrument. Bypassing the insolvent intermediary, the mechanism thus transfers the funds and, where applicable, the benefit of the deposit insurance, directly from the paying party, the customer of the insolvent institution, to the holder of the bank draft or money order.² Obviously, this rationale does not apply to the letter of credit or the accepted bill of exchange where normally there are no prepaid funds to which a trust can be attached. Consequently, neither the letter of credit nor the accepted bill of exchange is a “similar instrument” to the bank draft or the money order so as to be a “priority payment instrument”.¹² This is true even where the funds used for the purchase of the bank draft or money order have been lent by the issuing institution (or provided under an overdraft facility).

Finally, the situations where priority is stated not to be accorded to priority payment instruments may also support the exclusion of the irrevocable credit from such instruments. First, under section 31(5) of the Canadian Payments Association Act, no priority is to be accorded to the payment of a priority payment instrument “issued … with a view to giving the drawee … a preference over the other creditors of the insolvent member”. This supports the view that a priority payment instrument must have a drawee-funds holder, which is not the case in connection with the letter of credit. Second, under section 31(1) of the Act, “a money order, bank draft or similar instrument issued by a member to another member for the purpose of effecting a payment between those members” is not a priority payment instrument. It is thus an instrument purporting to carry out inter-member payment, rather than to embody a mere interbank obligation, which is excluded.

The latter conclusion was reached in Barclays Bank,³ which dealt with a letter of credit issued by the insolvent bank in favour of another bank. In fact, it is on this point that the decision of the court below was reversed⁴ so as to facilitate the ultimate decision by the Alberta Court of Appeal under which the interbank letter of credit qualified as a priority payment instrument.

13 Supra note 5 at 315 318.

14 Ibid., at 315. Conversely, the Court of Appeal affirmed the lower court's decision; criticized here, under which demand for payment under the credit qualified as a priority payment instrument. Ibid., at 312.
In effect, Barclays Bank held that while a letter of credit is a “similar instrument issued by a ... member” (so as to be covered by the first definition of section 31(1) of the Canadian Payments Association Act), the interbank letter of credit is not a “similar instrument issued by a member to another member for the purpose of effecting payment between those members” (within the meaning of the second definition of section 31(1) of the Act). By itself such interpretation looks plausible, at least at first blush. Yet, this interpretation may suggest the existence of a letter of credit, being a “similar instrument” under both definitions, which is nevertheless covered by the second definition so as to be excluded from the category of “priority payment instruments” on grounds of “effecting payment between ... members”. More importantly, treating the letter of credit as a “similar instrument”, thus constituting *356 a “priority payment instrument”, overlooks the inevitable existence of exceptions which, by no stretch of the imagination, fall into the second definition.

Indeed, a close reading of the judgment reveals that according to Berger J.A., and irrespective of the scope of the second definition, not all types of letters of credit qualify as priority payment instruments within the first definition. Rather, he stressed that in the fact of the case, the letter of credit did not require the demand for payment to be supported by “some independent evidence of its validity” and in fact “[i]t was more in the nature of a first demand credit guaranty not unlike a bank draft or money order”. Presumably, in Berger J.A.’s view, only such a letter of credit provides the required “assurance of payment” which is in his opinion “[t]he common feature of priority payment instruments”. He thus felt compelled to create exceptions to types of instruments covered by the first definition by reading qualifications to the first definition itself rather than interpreting the second definition which purports to provide for the exceptions.

15 Supra note 5 at 314.
16 Ibid., at 315.
17 Ibid., at 313.

Furthermore, he was cognizant that additional limitations are called for and went on to acknowledge that in fact “[t]he common feature of priority payment instruments is the assurance of payment so long as the issuing bank has funds”. But if so, it is hard to see how the letter of credit, even the one payable on demand and without documentary support, shares such a feature; typically it is not issued against customer’s funds put in advance at the issuing bank’s disposal.

18 Ibid.

Anticipating this argument, Berger J.A. relied on Crawford, according to whom “[o]n a functional view” the letter of credit is “quite similar” to a money order or bank draft “if the applicant for the credit has prepaid the bank the sum payable under the credit, or undertaken to pay and provided security for that obligation”. Yet Crawford goes on to acknowledge that “[t]he former would be very rare.” However, *357 Berger J.A. recognized that control of the funds by the issuing bank, namely prepayment, is “[t]he common feature of priority payment instruments.” In fact, the condition may even have not been met in Barclays Bank. While Crawford notes that in contrast to prepayment the provision of security to the issuing bank is common, as discussed below, this is a situation not quite “similar” to money orders and bank drafts where prepayment is the norm.

19 Ibid., at 315.
20 Supra note 1 at 869.
21 Ibid.
Ultimately, Crawford cites “the policy of promoting ... the commercial reliance upon the credits of Canadian banks” as a rationale for protecting the credit beneficiary. This indeed is a powerful argument which may seriously be considered by Parliament. Yet it fails to either obscure or overcome the fundamental differences between money orders and bank drafts on one hand and letters of credit on the other and make them “similar”. The overall policy underlying the distribution of assets in collective insolvency proceedings is that of equal distribution of assets among creditors. While it is recognized that such policy is subject to exceptions, those must be spelled out clearly by statute.

Admittedly, where the issuing bank’s obligation on a letter of credit is secured by the applicant’s assets, there is some similarity between the letter of credit and the bank draft or the money order. In each case, priority will effectively pass on to the beneficiary the benefit of the customer’s assets and not of the issuing insolvent bank’s other property. This indeed must be the functional similarity addressed by Crawford. Nevertheless, security may be less liquid than prepaid funds in the account. In connection with security, there may also be problems of evaluation, adequacy and enforcement. All this makes the provision of security less and less “similar” to prepayment, which is common to bank drafts and money orders, so as to accord them priority. At the same time, and notwithstanding Berger J.A.’s position, it is hard to see why documentary demand, as opposed to unconditional demand, reduces the assurance of payment so as not to accord priority to the payment of a documentary credit on which the insolvent issuer’s obligation is fully secured.

On the whole, the statutory treatment of priority payment instruments under the Canadian Payments Association Act is quite straightforward. True, clarification is required on several points. First, the rationale of placing the payment of such instruments behind certified cheques is not all that apparent. As well, as indicated, it is not all that clear whether personal money orders are priority payment instruments. At the same time, the policy of according priority to instruments payable on demand and drawn on existing funds set aside in advance to meet them, is clearly manifested and must be respected. This policy does not facilitate the inclusion of the letter of credit.

According to Barclays Bank, from all types of letters of credit, it is only the prepaid, or at least “secured”, credit payable on demand, that constitutes a priority payment instrument. To cover it in the definition, there is, however, an immediate need to refine, adjust, and delimit the framework of the provision to meet situations not falling into it naturally. In the final analysis, the task of creating such boundaries ought better be left to the Legislature.

It is noteworthy that in the U.S. pre 1995 U.C.C. § 5 117 explicitly provided for the priority as to prepaid funds held by an insolvent bank liable on a letter of credit. According to the Prefatory Note, the provision was omitted from the 1995 text due to coverage “by other law.”