Electronic Fund Transfers and the Bank's Right to Reverse a Credit Transfer: One Big Step (Backwards) for Banking Law, One Huge Leap (Forward) for Potential Fraud: *Pestana* v *Nedbank* (Act One, Scene Two)

WG SCHULZE
University of South Africa

1 Introduction

It has been argued that to a large extent any research on the legal principles underlying electronic credit transfers is no more than an exercise 'in search of law where little is to be found at present' (see Melanie L Fein *Law of Electronic Banking* (2000) atxd). Today this still holds true for South African banking lawyers. For this reason any new case law dealing with credit transfers (or electronic transfers, for that matter) is to be welcomed as it would hopefully not only contribute to our understanding of the topic, but also provides the opportunity for comment and reflection. (For a South African perspective of some of the legal theory applicable to electronic funds transfers, see Ina Meiring 'ATM's and EFTPOS: Some Legal Considerations'

Cite as: (2008) 20 *SA Merc U* 290-297.

(1987) 9 *Modem Business Law* 115; Coenraad Visser 'The Evolution of Electronic Payment Systems' (1989) 1 *SA Merc U* 189; WG Schulze 'E-Money and Electronic Fund Transfers. A Shortlist of Some of the Unresolved Issues' 2004 (16) SA *Merc U* 50; WG Schulze 'Countermanding an Electronic Funds Transfer: The Supreme Court of Appeal Takes a Second Bite at the Cherry' (2004) 16 *SA Merc U* 667; FR Malan & JT Pretorius 'Credit Transfers in South African Law (1)' (2006) 69 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 594; FR Malan & JT Pretorius 'Credit Transfers in South African Law (2)' (2007) 70 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 1; and WG Schulze 'Electronic Fund Transfers and the Bank's Right to Reverse a Credit Transfer: One Small Step for Banking Law, One Huge Leap for Banks' ('Schulze *Pestana*') (2007) 19 *SA Merc LJ* 379.)

The recent decision in *Pestana* v *Nedbank Ltd* (2008 (3) SA 466 (W), the *'Pestana* appeal') which dealt with a credit transfer is therefore a welcome addition to the modest body of South African case law on this area of our banking law. However, the *Pestana* appeal, it appears, has raised more questions than it provided answers to South African banking lawyers searching for a guide through the maze of problems and uncertainties underlying the law relating to electronic fund transfers.

For an examination of the impact of the decision in the *Pestana* appeal, it is necessary first to refer very briefly to the decision in the Court a quo (for a more detailed discussion, see Schulze *Pestana* at 379 et seq). *Pestana v Nedbank Ltd* (unreported, WLD, 29 May 2005 (case no 04/27732)) was a stated case in terms of Rule 33(1) and (2) of the Uniform Rules of Court. Because it was a stated case the record does not include the pleadings.

The salient facts were as follows: On 4 February 2004, at 8:44 am, Nedbank's Head Office in Rivonia was appointed by the South African Revenue Service ('SARS') as an 'agent' in terms of s 99 of the Income Tax Act 58 of 1962 ('the Act'). Section 99 of the Act provides for the appointment of an agent to pay monies over which are due to SARS. It was common cause that one Pestana ('the first Pestana') owed SARS in excess of R340m. The first Pestana had an account with Nedbank. At the time when Nedbank was appointed as an agent for the paying over of tax money owed to SARS by the first Pestana, he had a credit balance of R496 540,40 with Nedbank.

It was further common cause that on 4 February 2004, at 11:33 am, the first Pestana instructed a Nedbank employee at Carltonville, who was unaware of the appointment of the bank as a s 99 agent, to transfer the sum of R480 000 from his account to that of the plaintiff, also called Pestena ('the second Pestana). (The typed manuscript of the judgment does not clarify the nature of the relationship between the two Pestanas; I have it on good authority, though, that the second Pestana was the first Pestana's father.) This occurred at a time when Nedbank's head office had not yet informed its Carltonville branch of the s 99 notice to pay the first Pestana's taxt debt to SARS. The transfer was effected through Nedbank's internal credit system as the plaintiff (the second

Pestana) and the first Pestana were both clients of Nedbank. This was a so-called 'in-house payment' (see further par 3.1 below). Upon discovery of the error, Nedbank reversed the credit which had been passed to the plaintiff and paid the sum of R490 000 from the second Pestana's account to SARS in compliance with the s 99 notice (see pars 1-12 of the unreported judgment).

The plaintiff (second Pestana) then instituted an action against Nedbank on the basis that the latter had acted without his express authority and/or instructions when it reversed the credit.

The crisp question before the Court was whether Nedbank, by virtue of the s 99 notice sent by SARS to Nedbank's Head Office in Rivonia, entitled the Carltonville branch of Nedbank to reverse the credit entry without any authority from the plaintiff.

The Court, per Mathopo J, held (in par 20) that notification in terms of s 99 of the Act to Nedbank's Head office was sufficient or proper notice to the Carltonville branch (see s 170 of the Companies Act 61 of 1973).

The Court further held that Nedbank was entitled to reverse the credit in the plaintiff's account since the bank employee at the Carltonville branch who had passed the credit, did so erroneously or in the mistaken belief that there was no prior claim on the money (see in par 21). It reasoned that had the SARS notice been complied with prior to the instruction by Pestana, there would not have been any money left in the account and consequently that the instruction could not have been given effect to (see in par 22).

Finally, the Court reasoned, and in my view correctly, that Nedbank could not be precluded from looking behind the true state of affairs (ie, the erroneous transaction) and reversing a credit entry previously made in the account of the plaintiff. The plaintiff was therefore not entitled to the credit which was passed erroneously to his account.

The plaintiff appealed against the decision.

2 The Decision in the *Pestana* Appeal

On appeal before a Full Bench of the Witwatersrand Local Division, the Court, per Schwartzman J (Goldstein J & Tshiqi J concurring), was at pains to emphasise that as a court of appeal it was their 'duty to ascertain whether the court [a quo] came to the correct conclusion *on the case submitted to it*' (in par 5, emphasis added). Thus, the Court was confined to those facts presented to the Court a quo. (I will return in more detail to this important point in par 3 below.)

In considering the appeal, the Court reasoned that there were two things that the s 99 notice did not do. Firstly, it did not freeze the first Pestana's account; and secondly, it did not transfer or effect a cession of the funds in the first Pestana's account to SARS (see in par 10).

The Court further reasoned that on 4 February 2004, when Nedbank made the credit transfer, it could only have had one intention and that would have affected both its clients, the first Pestana and the second Pestana. It was not

possible for Nedbank to intend to accept payment on behalf of the second Pestana while simultaneously intending, on behalf of the first Pestana, not to pay (see in pars 12 and 13).

Once Nedbank intended to pay the second Pestana unconditionally on behalf of the first Pestana, it could not intend not to accept (ie, by way of electronic book entry) payment on behalf of the second Pestana. If the payment to the second Pestana, or the crediting of his account, was unconditional, it follows that Nedbank could not unilaterally reverse the credit (see in par 16.1).

In the present case there was, at best for Nedbank, a mistake in motive when it transferred the money to the second Pestana's account (see in par 17). Such mistake in motive, so the Court thought, did not entitle Nedbank to reverse the credit transfer.

The appeal was accordingly allowed with costs.

3 Comment

3.1 General

Before commenting on the decision in the *Pestana* appeal, it is perhaps apt first to provide a basic analysis of the operation of a direct credit transfer. Nowadays the overwhelming majority of, if not all, such transfers are done electronically.

While electronic transfers, and specifically the electronic clearing process, are conceptually no different from the clearing of paper-payment transactions (eg, cheque clearing), the speed and the volume of electronic transfers create unique problems. One of the these concern the vexed issue of the reversal of an electronic transfer (see David Wame & Nicholas Elliott (eds) *Banking Litigation* (2005) at 289 et seq for a discussion of these problems).

Generally a credit transfer involves the following five steps (see J Vroegop 'The Time of Payment in Paper-based and Electronic Funds Transfer Systems' 1990 *Lloyds Maritime and Commercial Law Quarterly* 64):

- the payer's bank sends a message to the payee's bank;
- the payee's bank receives the message;
- the payee's bank completes processing the message;
- the payee's bank makes the funds available to the payee; and
- the payee's bank advises the payee that the funds are available.

Applied to the facts of the *Pestana* case, another way of describing the process, using the terminology frequently adopted (on the terminology employed in credit transfers, see Joan Wadsley & Graham Penn *The Law Relating to Domestic Banking* 2 ed (2000) at 372), may be as follows: The payer (the first Pestana) transmits an instruction to his bank (Nedbank) to credit a sum of money (R480 000) from his account to the account of the payee (the second Pestana); this instruction is a payment order; the first Pestana is the sender and the second Pestana's bank (which in the *Pestana*

case was the same bank as that of the first Pestana) is the receiving bank of the payment order; the second Pestana is the payee.

The first Pestana's bank may execute its customer's order by 'issuing an instruction to itself' (usually it issues an instruction to another bank where the payee is a customer with another bank) to credit the second Pestana's account; the instruction from the bank is also known as a payment order.

This series of transactions is known as the funds transfer. The first Pestana is the originator, Nedbank is the originator's bank, the second Pestana is the payee or beneficiary, and his bank is the beneficiary's bank or the receiving bank. In the *Pestana* case, only one bank, Nedbank, was involved and it fulfilled the roles of both the originator's bank and the beneficiary's bank.

The *Pestana* case constituted the simplest model of a funds transfer, namely an in-house payment (ie, only one bank was involved). A slightly more complex situation arises where the payer and the payee are customers at the same bank, but at different branches. Even more complex - and more usual - is where the payer and the payee bank at different banks. Frequently, a number of other banks may also be involved. This would be the case in international transactions, where the principal banks may use overseas' correspondent banks or settlement banks. Settlement banks come into play where the principal banks are not members of the overseas payment system involved.

The roles of the banks concerned in funds transfers are largely governed by bilateral contracts (inter-bank agreements) between them. Often these relationships between banks are governed by multi-lateral agreements between a number of banks. In the English case of *Royal Products Ltd v Midland Bank Ltd* ([1981] Com LR 93), the Court held that the relationships between banks involved in a funds-transfer transaction are governed by the rules of agency (see Wadsley & Penn op cit at 373).

I believe that this would hold true also for the relationships between South African banks involved in a funds-transfer transaction. The relationships would first and foremost be governed by the provisions of any inter-bank agreement. These provisions, as well as the naturale of their relationship, would be governed by the common-law principles of representation.

In South African law, the relationship between the bank and its customer is one of mandate. As a result, all the principles of the law of representation apply to their relationship.

It is trite that the mandate given by the mandator to the mandatory must be legal. This includes a mandate which is in principle legal (like transferring an amount of money from one account to another) but which has an illegal aim, for example, to defraud the bank or, for that matter, any other party (see DJ Joubert *Die Suid-Afrikaanse Verteenwoordigingsreg* (1979) at 96-7; I will return to the relevance of fraud in the sphere of electronic transfers below).

3.2 The *Pestana* Appeal

As already mentioned, the Court was at pains to stress that 'as a court of appeal it is our duty to ascertain whether the court below came to the correct

conclusion *on the case submitted to it*' (in par 5, emphasis added). I believe that the carefully worded judgment of Schwartzman J suggests that the Court had a strong suspicion that everything were not as it should have been, but that its hands were tied by the fact that the case before it was in the form of a stated case.

I will limit my discussion and merely mention some examples of those aspects which were not put to the Court as part of Nedbank's stated case. I believe that the following four quotations from the reported decision suggest that had Nedbank's case been presented differently in the Court *a quo*, the outcome of the *Pestana* appeal could have been different:

- 'There were *no facts in the stated case* from which it can be said that payment to [the first Pestana], or the crediting of his account, was conditional' (in par 14, insertions and emphasis added).
- 'There is *no suggestion to the stated case* before this Court that [the first] Pestana or [the second Pestana] were party to theft or fraud' (in par 15, insertions and emphasis added).
- 'There is *nothing in the stated case* to suggest that [the first] Pestana or the [second Pestana] were the cause of the mistake [of transfering the money to the latter's account]' (in par 16.1, insertions and emphasis added).
- 'On *the facts of the stated case there is nothing* to suggest that the [second Pestana] knew or should have known that [Nedbank] had mistakenly credited his account with the R480 000' (in par 18, insertions and emphasis added).

There are, of course, usually an explanation why parties agreed to have certain facts included and other excluded from a stated case. Things were no different in the *Pestana* case. One can but speculate on the validity of these explanations and reasons for excluding certain facts from the stated case. What one does not need to speculate about is the fact that the Court in *Pestana* was restricted in its dealing with the matter to the facts as agreed upon in the stated case. I believe that the Court's remark in the second quotation above suggests that it had strong suspicions that there was fraud in the present case. I will return to the aspect of fraud shortly.

In passing, the Court's reasoning in the third quotation above also merits a brief comment. Although it is true that there was nothing to suggest that either one of the two Pestanas was *the cause of the mistake* to transfer the money to the second Pestana's account, it cannot be denied that the first Pestana was the *cause of the money to be transferred*, period. It was he, and no one else, who gave the mandate to the Carltonville branch of Nedbank to transfer the money to the second Pestana's account. And was this mandate perhaps not given with the intention to defraud either SARS or Nedbank?

If the duty of a court of appeal is indeed to limit itself to 'ascertain whether the Court below came to the correct conclusion on the case submitted to it', the Full Bench in the *Pestana* case was probably correct in its finding.

However, the question remains whether a court of appeal should be prevented from going beyond this narrowly defined definition of its duties

where there is a possibility of fraud or other illegality being involved. The available facts from the *Pestana* case have a decidedly suspicious ring to them. Unfortunately the typed judgment of both the trial court and the court of appeal do not include the pleadings and therefore do not reveal all the relevant facts.

First, it is not revealed what the exact nature of the relationship was between the two Pestanas. It could hardly have been a coincidence that the amount was transferred to someone (the second Pestana) who was, in all likelihood, a close relative of the transferor. I have already mentioned that the second Pestana was apparently the first Pestana's father.

Secondly, it is highly unlikely that it was a mere coincidence that the first Pestana for all intents and purposes 'emptied' his account on the same day when SARS issued Nedbank with the s 99 notice, instructing it to effect a credit transfer to another account (which happened to be held by his father). As a matter of fact, the first Pestana gave the instruction (mandate) to Nedbank to transfer the money to the account of the second Pestana *less than three hours* after the s 99 notice had been served upon Nedbank. Was the first Pestana perhaps alerted to the fact that the s 99 notice had been issued? Did the first Pestana perhaps receive word of the s 99 notice by someone working at SARS or perhaps even at Nedbank itself?

If the first Pestana had indeed been alerted to the fact that the s 99 notice was sent to Nedbank earlier that morning, and had that knowledge then prompted him to instruct the Carltonville branch to transfer the money from his account to that of the second Pestana, the mandate given by the first Pestana to the Carltonville branch of Nedbank to transfer the money was tainted with fraud. In short, the mandate given by the first Pestana to Nedbank to transfer the money was in all probability not a valid mandate as it was given in order to commit a crime (ie, to frustrate the aims of the s 99 notice and to avoid outstanding tax being paid over to SARS). The transfer of the money could therefore not have been valid and if Nedbank had suffered any damage by fulfilling its mandate (as happened in the *Pestana* case), it would be entitled to claim damages from the mandator (the first Pestana) (see Joubert op cit at 97). However, in the present case the transfer of the money took place in 2004, which means that Nedbank's claim against the first Pestana may already have become prescribed.

Further, one cannot leave unchallenged the decision by the Court that an electronic transfer is unconditional and that it cannot be reversed by a bank should it become aware that the recipient of the money was not entitled to it. There could be a number of valid reasons why a bank would be entitled to reverse a credit transfer unilaterally: for example, in the case of mistaken identity (ie, the money was transferred to the wrong person); or where the wrong amount has been transferred; or where the right amount was transferred to the right person but on the wrong date (ie, prematurely); or where the right amount was transferred to the right person on the right day (as has happened in the *Pestana* case) but the bank was not entitled to effect the

transfer (because the s 99 notice by SARS had already reached Nedbank at the time when it transferred the money). In all these cases the receiver surely cannot claim to be entitled to the money so transferred.

But there is also a further reason why an electronic transfer cannot be regarded as unconditional. I believe that even in those cases where the bank-client agreement does not expressly provide for the bank's right to reverse the transfer and therefore that the transfer is conditional, the bank-client agreement contains a naturale to that effect, especially where the bank discovers fraud on the part of the originator after the latter had given the payment order to the bank.

I believe that to minimise the effect of the decision in the *Pestana* appeal on the South African banking law, it should not carry any more weight than is absolutely necessary. This could be achieve by regarding it for what it is worth, namely a decision based on the particular facts as embodied in the stated case before the Court a quo. I am of the view that notwithstanding its findings regarding the so-called 'uncondionality of electronic transfers', the decision in the *Pestana* appeal contains no general principle regarding the 'unconditionality' of credit transfers. For this reason, the *Pestana* case does not lay down any (new) legal principle which a future court would be bound to follow.

To avoid the type of situation in which Nedbank found itself in the *Pestana* case, banks should consider in future including an express term in the contract with their clients that they will have the right unilaterally to reverse a credit transfer (within a reasonable time and where such reversal is still physically possible) should it appear that the client was not entitled to the money in the first place. It goes without saying that the decision to reverse the transfer should be restricted to those cases where the transfer was made by the bank (and not also, eg, where the transfer was made by a client through the Internet or at an ATM). Generally banks should not become involved in contractual disputes between clients (and third parties) concerning the reversal of electronic money transfers where one client wishes to reverse money which he or she has transferred to another client or to a third party. In short, banks should preferably not get involved in disputes regarding any underlying contractual relationship involving their clients.

However, were crime (eg, fraud) is involved, banks could or should not turn a blind eye to proceedings. In the case of fraud, public policy dictates that a bank should do everything in its power to prevent or expose such criminal conduct. This is an acknowledged principle in other spheres of banking law too. For example, in the case of documentary letters of credit it is well established that where the beneficiary in terms of the credit has submitted forged or falsified documents, the bank will be allowed to refuse payment on the credit, notwithstanding the trite principle that the letter of credit is independent from any underlying transaction (on documentary letters of credit, including the fraud exception to the doctrines underlying them, see JP van Niekerk & WG Schulze *The South African Law of International Trade: Selected Topics* 2 ed (2006) at 306 et seq.)