

**ASPECTS OF TRADITIONAL SECURITISATION IN  
SOUTH AFRICAN LAW**

by

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<b>TABLE OF CONTENTS</b>	<b>3</b>
<b>SUMMARY</b>	<b>9</b>
<b>KEY TERMS</b>	<b>11</b>
<b>ACKNOWLEDGEMENTS</b>	<b>13</b>
<b>CHAPTER 1 INTRODUCTION</b>	<b>15</b>
1.1 INTRODUCTION	15
1.2 METHODOLOGY	17
1.2.1 Comparative perspectives	17
1.2.2 Structuring of securitisation scheme	21
1.2.3 Regulatory considerations	21
1.2.4 True sale and insolvency-remoteness	21
1.2.5 Aspects that fall outside study	22
1.3 TERMINOLOGY	23
1.4 CONCLUDING REMARKS	24
<b>PART I TRADITIONAL SECURITISATION: GENERAL FORM AND FUNCTION</b>	<b>27</b>
<b>CHAPTER 2 Securitisation: general form and function</b>	<b>29</b>
2.1 INTRODUCTION	29
2.2 ADVANTAGES OF SECURITISATION	30
2.2.1 Improved liquidity	31
2.2.2 Diversification of funding sources	31
2.2.3 Better interest rates	32
2.2.4 Improved risk management	32
2.2.5 Accountancy-related advantages	33
2.2.6 Non-rational and illegal motivations	34
2.2.6.1 Trends	34
2.2.6.2 Judgment-proofing	34
2.2.6.3 Money laundering and fraud	36
2.3 SPECIAL PURPOSE VEHICLE (SPV)	37
2.3.1 Capitalisation	39
2.3.2 Corporate governance	41
2.3.3 Insulating SPV against insolvency	43
2.4 IDENTIFICATION AND TRANSFER OF APPROPRIATE ASSETS TO SPV	45
2.5 CREDIT ENHANCEMENT	48
2.6 RATING AGENCIES	50
2.6.1 Factors considered when rating securitisation	51
2.6.2 Regulation of rating agencies	52
2.6.3 Liability towards third parties	54
2.7 SERVICER	57
2.8 SECURITY IN FAVOUR OF TRUSTEE FOR DEBENTURE-HOLDERS	58
2.8.1 Form of security	60
2.8.2 Security structures	61
2.8.2.1 Security SPV	62
2.8.2.2 Legal form of trust for debenture-holders	66
2.8.2.2.1 Agency construction	67
2.8.2.2.2 Trust construction	73
2.8.2.2.2.1 Aspects of Companies Act 61 of 1973	75

2.8.2.2.2	Transfer of ownership	78
2.8.2.2.3	Trust for debenture-holders as bewind trust	79
2.8.2.2.4	Trust for debenture-holders as true trust	81
2.8.2.2.3	Trust for debenture-stockholders	83
2.8.3	Trustee for debenture-holders	85
2.9	DISTINCTION BETWEEN SECURITISATION AND OTHER FORMS OF STRUCTURED FINANCE	89
2.10	CONCLUSION	91
<b>PART II COMPARATIVE PERSPECTIVES</b>		<b>95</b>
<b>CHAPTER 3 English Law</b>		<b>97</b>
3.1	INTRODUCTION	97
3.2	LEGAL AND EQUITABLE CHARGES	97
3.2.1	Characteristic elements of floating charges	101
3.2.1.1	Charges over book debts	103
3.2.2	Implied terms of floating charge agreements	110
3.2.2.1	Business continuance	112
3.2.2.2	Business-dealing licence	113
3.2.2.3	Crystallisation terms	117
3.2.3	Crystallisation	117
3.2.4	Receivership	121
3.2.5	Advantages of floating charges	123
3.2.6	Disadvantages of floating charges	124
3.3	SECURITISATION: SPECIFIC CONSIDERATIONS	128
3.3.1	Regulatory considerations	129
3.3.1.1	Financial Services and Markets Act of 2000	129
3.3.1.2	Companies Act 1985	130
3.3.2	Transfer of rights and 'true sale' requirement	131
3.3.2.1	Equitable assignment	132
3.3.2.2	Charge in favour of debenture trustee	135
3.3.2.3	Recharacterisation of sale as security	136
3.3.2.4	Non-assignment clauses	139
3.3.3	Bankruptcy-remoteness from originator	141
3.3.3.1	Transactions at an undervalue	142
3.3.3.2	Preferences	146
3.3.3.3	Transactions that defraud creditors	148
3.4	CONCLUSION	149
<b>CHAPTER 4 American Law</b>		<b>153</b>
4.1	INTRODUCTION	153
4.1.1	Securitisation in United States of America	154
4.2	REVISED ARTICLE 9 OF UNIFORM COMMERCIAL CODE	156
4.2.1	Security interests in property	159
4.2.1.1	Attachment of security interest	160
4.2.1.2	Perfection of security interest	162
4.2.1.2.1	Notice filing	162
4.2.1.2.2	Perfection without notice filing	164
4.2.1.3	Priorities among conflicting security interests	165
4.2.2	Sale of accounts, chattel paper, payment intangibles and promissory notes	166
4.3	SECURITISATION: SPECIFIC CONSIDERATIONS	169
4.3.1	Regulatory considerations	169
4.3.1.1	Investment Company Act of 1940	169
4.3.1.2	Securities Act of 1933 and Securities Exchange Act of 1934	173
4.3.1.3	Consumer protection legislation	174
4.3.2	Bankruptcy law considerations	179
4.3.2.1	Transfer of rights and 'true sale' requirement	180
4.3.2.1.1	Bankruptcy Reform Act of 2001	180
4.3.2.1.2	Future legislative intervention	184

4.3.2.1.3	Current position	186
4.3.2.2	Equitable doctrine of substantive consolidation	189
4.3.2.3	Avoidance provisions of Bankruptcy Code	194
4.3.2.3.1	Fraudulent transfers	197
4.3.2.3.2	Constructively fraudulent transfers	198
4.3.2.4	Doctrine of enterprise liability	199
4.4	CONCLUSION	200
<b>PART III SOUTH AFRICAN LAW</b>		<b>203</b>
<b>CHAPTER 5 Debt Financing of Companies</b>		<b>205</b>
5.1	COMPANY DEBT	205
5.1.1	Gearing	206
5.1.2	Insider debt	208
5.2	DEBENTURES	210
5.2.1	Definition	211
5.2.2	Debenture stock	216
5.2.3	Security	217
5.2.4	Provisions of Companies Bill 61 of 2008	218
5.3	PURPOSE OF SECURITY	219
5.4	SECURING DEBT IN SOUTH AFRICA	220
5.4.1	General	220
5.4.2	General notarial bonds	224
5.4.2.1	Priority	224
5.4.2.2	Alienation of encumbered security objects	225
5.4.2.3	Negative pledge clauses	227
5.4.2.4	Perfecting clauses	228
5.4.2.4.1	Legislative intervention required	239
5.4.3	Security by means of claims	241
5.4.3.1	Pledge of claims	242
5.4.3.2	Fiduciary security cession	245
5.5	FORM OF SECURITY GRANTED TO SECURITY SPV	248
5.5.1	General notarial bonds	248
5.5.2	Pledge of claims	251
5.5.3	Fiduciary security cession	251
5.6	CONCLUSION	252
<b>CHAPTER 6 Regulatory Considerations for Traditional Securitisations</b>		<b>259</b>
6.1	INTRODUCTION	259
6.2	REGULATORY HISTORY OF SECURITISATION IN SOUTH AFRICA	259
6.2.1	Securitisation Notice, 1992	260
6.2.2	Commercial Paper Notice, 1994	262
6.2.3	Securitisation Notice, 2001	264
6.2.4	Securitisation Notice, 2004	268
6.2.5	Securitisation Notice, 2008	271
6.3	BANKS ACT 94 OF 1990	274
6.3.1	Banks Amendment Act 20 of 2007	277
6.4	NATIONAL CREDIT ACT 34 OF 2005	279
6.4.1	Over-indebtedness and reckless credit	281
6.4.2	Unlawful credit agreements	286
6.4.3	Registration as credit provider	287
6.5	COMPANIES ACT 61 OF 1973	289
6.5.1	Provisions of Companies Act 61 of 1973 that are important for originator	290
6.5.1.1	Disposal of undertaking or greater part of assets of company	290
6.5.1.2	Affected transactions	292
6.5.1.3	Conflicts of interest	294
6.5.1.4	Company secretary	295
6.5.1.5	Auditor	296
6.5.2	Provisions of Companies Act 61 of 1973 important for SPV	296

6.5.2.1	Disclosure requirements	296
6.5.2.2	Auditor	298
6.6	COMPANIES BILL 61 OF 2008	298
6.6.1	Memorandum of Incorporation	298
6.6.2	<i>Ultra vires</i> doctrine and doctrine of constructive notice	300
6.6.3	Separation of Powers	303
6.6.4	Affected Transactions	303
6.7	SECURITIES SERVICES ACT 36 OF 2004	305
6.8	COLLECTIVE INVESTMENT SCHEMES CONTROL ACT 45 OF 2002	306
6.9	DEBT COLLECTORS ACT 114 OF 1998	310
6.10	CONCLUSION	313
<b>CHAPTER 7 Transfer of claims and 'True Sale' Requirement</b>		<b>317</b>
7.1	INTRODUCTION	317
7.2	AGREEMENTS BETWEEN ORIGINATOR AND SPV	317
7.2.1	Obligatory agreement: contract of sale	318
7.2.2	Transfer agreement	319
7.2.2.1	Delegation	320
7.2.2.2	Cession	324
7.2.2.2.1	Delivery of document	324
7.2.2.2.2	Valid causa	327
7.2.2.2.3	Role of notice to debtor	328
7.2.2.2.4	Set-off	329
7.2.2.2.5	Defences	330
7.2.2.2.6	Case for codification	330
7.2.3	Transfer of security rights	331
7.2.3.1	Covering bonds	334
7.2.3.2	Sureties	336
7.2.3.3	Security by way of cession <i>in securitatem debiti</i>	337
7.2.3.4	Instalment sale agreements	337
7.2.4	Transfer of future claims	339
7.3	RELATIONSHIP BETWEEN SPV AND SERVICER	344
7.3.1	Servicer as representative of SPV	346
7.3.2	Servicer as mandatary <i>in rem suam</i> of SPV	347
7.3.2.1	Application to relationship between servicer and SPV	353
7.3.3	Servicer as cessionary for collecting purposes	353
7.4	SIMULATED TRANSACTIONS	357
7.4.1	Simulated transactions in South African law	359
7.4.2	Application to securitisation	362
7.5	CONCLUSION	367
<b>CHAPTER 8 Insolvency Law Considerations in Securitisation</b>		<b>375</b>
8.1	INTRODUCTION	375
8.2	IMPEACHABLE TRANSACTIONS IN TERMS OF INSOLVENCY ACT	378
8.2.1	Dispositions without value	379
8.2.1.1	Meaning of 'disposition'	379
8.2.1.2	Meaning of 'value'	381
8.2.2	Voidable preferences	383
8.2.2.1	Defence available to person who received disposition	384
8.2.2.1.1	Ordinary course of business	384
8.2.2.1.2	Intention to prefer	386
8.2.3	Undue preferences	388
8.2.4	Collusive dispositions	389
8.2.5	Indemnity to creditors and rights of third parties	391
8.3	TRANSFER OF BUSINESS BY TRADER	393
8.4	DISPOSITIONS VOIDABLE AT COMMON LAW: <i>ACTIO PAULIANA</i>	397
8.5	CONCLUSION	399
<b>CHAPTER 9 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS</b>		<b>403</b>
9.1	STRUCTURE OF SECURITISATION SCHEME	403

9.1.1	Rating agencies	404
9.1.2	Security SPV	405
9.1.3	Trust for debenture-holders	406
9.1.4	Form of security in favour of security SPV	408
9.2	REGULATORY CONSIDERATIONS FOR TRADITIONAL SECURITISATION	410
9.2.1	Securitisation Notice, 2008	410
9.2.2	Banks Act 94 of 1990	413
9.2.3	National Credit Act 34 of 2005	414
9.2.4	Companies Act 61 of 1973	416
9.2.5	Companies Bill 61 of 2008	416
9.2.6	Collective Investment Schemes Control Act 45 of 2002	417
9.2.7	Debt Collectors Act 114 of 1998	418
9.3	TRUE SALE REQUIREMENT AND INSOLVENCY-REMOTENESS	419
9.3.1	Sale as obligatory agreement between originator and SPV	419
9.3.2	Transfer agreement between originator and SPV	419
9.3.3	Transfer of security rights	420
9.3.3.1	Transfer of covering bonds	421
9.3.3.2	Transfer of instalment sale agreements	422
9.3.4	Transfer of future claims	423
9.3.5	Relationship between SPV and servicer	423
9.3.6	Simulated transactions	425
9.3.7	Impeachability of sale of assets on originator's insolvency	426
9.3.8	Effect of impeachment on third parties	428
9.3.9	Securitisation Notice and impeachment	428
9.3.10	Notice requirements in terms of section 34 of Insolvency Act 24 of 1936	429
9.4	RECOMMENDATIONS	429
9.4.1	Rating agencies	429
9.4.2	Security SPV and trustee for debenture-holders	430
9.4.3	Form of security in favour of security SPV	430
9.4.4	Perfection of general notarial bonds	430
9.4.5	Securitisation Notice	431
9.4.6	Exemption from the Collective Investment Schemes Control Act 45 of 2002	432
9.4.7	Transfer by way of cession	432
9.4.8	Relationship between SPV and servicer	433
9.4.9	Solvency of originator on transfer of assets	433
9.4.10	Section 34 of Insolvency Act 24 of 1936	433
9.5	FINAL REMARKS	433
<b>CHAPTER 10 Bibliography</b>		<b>435</b>
10.1	BOOKS	435
10.2	ARTICLES	442
10.3	OTHER PUBLICATIONS	452
10.4	LIST OF CASES	455
10.4.1	South Africa	455
10.4.2	Southern Africa	460
10.4.3	England	460
10.4.4	Australia	462
10.4.5	New Zealand	463
10.4.6	United States of America	463
10.5	LIST OF LEGISLATION	464
10.5.1	South Africa	464
10.5.1.1	Acts	464
10.5.1.2	Bills	465
10.5.1.3	Draft Bills	465
10.5.1.4	Regulations and Notices	465
10.5.2	England	465
10.5.2.1	Acts	465
10.5.3	United States of America	466
10.5.3.1	Acts	466
10.5.3.2	State Acts	466

10.5.3.3	Regulations	466
10.6	TABLE OF FIGURES	467
<b>INDEX</b>		<b>469</b>



## SUMMARY

This thesis considers the typical structure and requirements of a traditional securitisation scheme in South Africa. The models used in other jurisdictions cannot be applied unchanged in South Africa. South African securitisation structures make use of a security special purpose vehicle (SPV), because of uncertainties about the provisions of the Companies Act 61 of 1973 relating to the trustee for debenture-holders. An evaluation of the functioning of a security SPV leads to the conclusion that a trustee for debenture-holders should still be appointed within the security SPV structure to represent the interests of the investors. The trust for debenture-holders can be a true trust. The use of general notarial bonds over claims, pledges of claims and fiduciary security cession is examined to determine the effectiveness of each one during securitisation.

Aspects of several Acts, Notices and other regulatory measures are considered where they are relevant to securitisation. Of specific importance is the Exemption Notice Relating to Securitisation Schemes, 2008. The Notice requires that both rights and obligations of the originator must be transferred to the SPV. The requirement that the obligations of the originator must be transferred leads to the conclusion that the Notice requires a transfer of claims by means of cession and a transfer of duties by means of delegation. For several reasons, delegation is not a suitable method of transfer during securitisation. Foremost among these reasons is that delegation is a form of novation, which means that the claims cease to exist and are replaced with new claims between the debtors and the SPV. Security rights that were accessory to these claims will then also cease to exist. The amendment to the Notice is recommended so that transfer of claims by means of cession will suffice for compliance with the Notice.

The South African courts' approach to simulated transactions is evaluated to determine the possibility that the sale of the assets to the SPV may be viewed as a simulated transaction. This thesis evaluates the provisions in insolvency law that could be raised to impeach the sale of the assets in the event of the originator's insolvency. The risk of avoidance of the transaction on either ground is small.



## KEY TERMS

Cession; cession for collecting purposes; debenture trust; disposition; fiduciary security cession; general notarial bond; insolvency-remoteness; originator; pledge of claims; rating agency; simulated transaction; special purpose vehicle; traditional securitisation; true sale requirement; trustee for debenture-holders



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I dedicate this work to my sons, Michael and Aedan, who have had to share their mother with a thesis since the day they were born. The three of you are what I have to show for the last decade of my life. I thank the Lord for such abundant blessings.



# CHAPTER 1 INTRODUCTION

## 1.1 INTRODUCTION

Traditional securitisation is the pooling of a homogenous group of income-producing assets, the sale of these assets by the original holder (originator) to an insolvency-remote third party (a special purpose vehicle or SPV)<sup>1</sup> and the issue by the SPV of marketable securities (typically debt instruments such as debentures) to finance the purchase of the assets. The transferred assets serve as security for the securities issued.<sup>2</sup> Traditional securitisation is further categorised as either asset-backed (property and claims) or revenue stream-backed (intellectual property and whole businesses) securitisation. This categorisation is based on the character of the transferred assets. The description of this category may be confusing at first glance – all assets transferred during the securitisation process must be able to generate the cash flows necessary to service the principal debt and interest of the securities issued.

Traditional securitisation must be distinguished from synthetic securitisation. In a synthetic securitisation the assets are not transferred to the SPV. Instead, the originator uses a credit derivative instrument to transfer the risk associated with the specified pool of assets to the SPV.<sup>3</sup> The SPV issues securities to finance the transaction. The principal debt and interest on the securities must be paid from the cash flow arising from the assets that serve as collateral and from the fees or premium paid by the originator to the SPV for accepting the risk.<sup>4</sup>

The main objective of securitisation is for the originator to obtain financing. An originator will opt to use securitisation rather than issuing debt securities if the benefits of securitisation outweigh its disadvantages, such as the high cost of the

<sup>1</sup> The abbreviation ‘SPV’ will be used throughout this thesis.

<sup>2</sup> For further definitions of traditional securitisation see GN 2, GG 30628 (1 January 2008) Notice on Banks Act 94 of 1990 – Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes), hereinafter referred to as ‘Securitisation Notice, 2008’, par 1 of the Schedule; Angela Itzikowitz & FR Malan “Asset Securitisation in South Africa” (1996) 8 *SA Merc LJ* 175; *Standard & Poor’s Asset Securitization Report: Glossary* at 22, available at <http://www.asreport.com/glossary.cfm> (accessed 9 May 2005).

<sup>3</sup> ‘Risk’ may refer to, among other things, the possibility of default (in the case of claims) or the possibility of the loss of profitability (in the case of intellectual property or whole businesses).

<sup>4</sup> Schedule, par 1 of Securitisation Notice, 2008.

transaction. The benefits of securitisation as opposed to other forms of financing are discussed in chapter 2.

Securitisation has not had a long history. The first securitisation was carried out in 1977 in the United States of America. It was an issue by the Bank of America, underwritten by Salomon Smith Barney. The first securitisations were aimed at improving the home loan market by increasing the funds available for loans to mortgage borrowers by United States thrifts, which are similar to building societies.<sup>5</sup> The first securitisation scheme in South Africa was carried out in 1989 by the United Building Society as the originator. The pooled assets were mortgage loans and they were sold to Mortgage Securities 101 (Pty) Ltd, the SPV created for the scheme. The securities issued to finance the transaction were floating-rate debentures.<sup>6</sup>

Legal opinion will usually be acquired during the structuring phase of a securitisation scheme as to whether the sale of the assets to the SPV will be a ‘true sale’. The procurement of such a legal opinion is a requirement of Securitisation Notice, 2008 when the originator of the scheme is a bank or a company within a banking group.<sup>7</sup> The requirements of Securitisation Notice, 2008 must be met by both bank and non-bank originators for the SPV to be exempted from falling under the definition of ‘the business of a bank’ in the Banks Act,<sup>8</sup> when the SPV offers its securities to the public.

However, even if the SPV does not intend to offer its securities to the public and therefore does not need to comply with Securitisation Notice, 2008, it is important that the transfer of the assets constitutes a true sale. A true sale will permanently remove the assets from the estate of the originator so that they will not be available to the originator’s creditors for attachment or to its liquidator if declared insolvent. The investors in the SPV depend on this insulation from the originator when they invest in the SPV, because they are not compensated for the business risks of the originator by way of interest.

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<sup>5</sup> Natasha Higman *Securitisation Clarified* (2004) at 6.

<sup>6</sup> See Itzikowitz & Malan 1996 *SA Merc LJ* at 183–185.

<sup>7</sup> Schedule, par 4(2)(b)(i).

<sup>8</sup> 94 of 1990.



Despite the importance of legal opinion during the structuring of the scheme, there has been almost no research in South African law on traditional securitisation.<sup>9</sup>

## 1.2 METHODOLOGY

Traditional securitisation is considered by examining three inter-related aspects, namely (1) the structuring of the securitisation scheme, (2) relevant legislative aspects and lastly, (3) the true sale requirement and insolvency-remoteness of the SPV. These aspects are also considered in the comparative chapters of the thesis.

Almost any asset of an originator can be securitised,<sup>10</sup> but the type of assets most often used is claims. This thesis will therefore only discuss the securitisation of claims.

### 1.2.1 Comparative perspectives

The law relating to securitisation in the United States of America<sup>11</sup> and in England is examined.<sup>12</sup> These are countries in which securitisation is used often, and in which potential problems in structuring, legislation and in achieving a true sale have been well explored and discussed in academic circles.

South African company law was to a great extent derived from English legislation<sup>13</sup> and, consequently, South African courts have introduced into law much of the English

<sup>9</sup> Only two articles have been published on the topic in accredited South African law journals, namely Itzikowitz & Malan 1996 *SA Merc LJ* at 175 and Susan Scott “An Introduction to the Securitisation of Claims Incorporating a Collective Security Arrangement” (2006) 18 *SA Merc LJ* 397.

<sup>10</sup> See par 2.4 for a brief outlay of the types of assets that may be securitised.

<sup>11</sup> Chapter 4.

<sup>12</sup> Chapter 3.

<sup>13</sup> The first company legislation in South Africa was the Cape Joint Stock Companies Limited Liability Act 23 of 1861. This Act was almost identical to the English Joint Stock Companies Act of 1844 (7 & 8 Vict c 110) and the Limited Liability Act of 1855 (18 & 19 Vict c 133). The colony of Natal followed the Cape legislation (Joint Stock Companies’ Limited Liability Law 10 of 1864) and so did the Republic of Transvaal (*De Akte van Maatschappijen met Beperkte Verantwoordelijkheid, Wet 5 van 1874*). Company legislation only followed much later in the Republic of the Orange Free State but its first attempt was also similar to the English model (*De Wet over Beperkte Verantwoordelijkheid van Naamloze Venootschappen, Hoofstuk C van de Wetboek van die Oranjevrijstaat van 1891*). The first consolidated companies legislation of the Union of South Africa was the Companies Act 46 of 1926 which was largely based on the English Companies (Consolidation) Act of 1908 (8 Edw 7 c 69). For a more detailed discussion of the development of company legislation in South Africa and the adoption of the English common law on companies see HS Cilliers, ML Benade, JJ Henning, JJ du Plessis, PA Delpont, L de Koker & JT Pretorius *Corporate Law* 3 ed (2000) at 18–28.

company law.<sup>14</sup> However, South African private law, which governs the transfer of rights and the creation of security rights, does not share such historical similarities with English law. Furthermore, English trust law was not received in South African law and forms no part of South African law. These distinctions must be kept in mind when the English model of securitisation is used locally.

In the chapter on English law the floating charge is discussed as English law's prime example of security over claims. The floating charge developed in conjunction with the debenture, a form of corporate debt, and the two are closely associated.<sup>15</sup> The system of creating security interests in property in the United States of America differs radically from that used in England and is discussed in detail. Although these jurisdictions both fall in the Anglo-American legal family, the differences in their law of personal property security lead to marked differences in their approach to securitisation. This is especially true for assignment of receivables. In English law the assignment of receivables during securitisation is done by way of equitable assignment in terms of the common law, while assignment of claims in American law resorts under the provisions of Article 9 of the Uniform Commercial Code.

Both comparative chapters in this thesis start with a discussion of the system of security over movable property used in that jurisdiction, focusing on security by means of claims. This is followed by regulatory considerations that have emerged from those jurisdictions. Lastly, the method used to transfer claims is examined. Possible remedies that may be used to hold that the transfer of the claims was not a sale are considered. So too whether bankruptcy law could be used to impeach the sale of the assets to the SPV.

Securitisation is available as a form of financing in the Netherlands and in Germany, but has not been met with as much enthusiasm there as in England and the

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<sup>14</sup> South African insolvency legislation also shows a strong English law influence. The Cape Ordinance 6 of 1843 may be described as the foundation of the law of insolvency in South Africa, since the insolvency provisions of Natal (Ordinance 24 of 1846), the Republic of the Orange Free State (Ordinance 9 of 1879) and the Republic of Transvaal (Ordinance 21 of 1880, later repealed and replaced with *Wet 13 van 1895*) were all largely based on it. The first uniform insolvency legislation of the Union of South Africa was the Insolvency Act 32 of 1916. It followed the structure of the Transvaal Act 13 of 1895, the latter being an adaptation of the Cape Ordinance. The common law of insolvency in South Africa is the Roman-Dutch law, but the courts do refer to the English law for guidance where Roman-Dutch law does not provide authority. For a detailed discussion of the historical development of insolvency law in South Africa see Eberhard Bertelsmann, Roger G Evans, Adam Harris, Michelle Kelly-Louw, Anneli Loubser, Melanie Roestoff, Alastair Smith, Leonie Stander & Lee Steyn *Mars The Law of Insolvency in South Africa* 9ed (2008) at 6–14.

<sup>15</sup> *In re Brightlife Ltd* [1987] Ch 200.

United States of America. The reasons for the slow rate of implementation of securitisation in the Netherlands are mostly economic.<sup>16</sup> However, there are certain provisions in Dutch law that make securitisation more difficult than in the Anglo-American jurisdictions. Foremost among these difficulties used to be the requirement in Dutch law that the debtor must be informed of a cession for the cession to take legal effect.<sup>17</sup> For several reasons the originator does not want to inform the debtors of the cession of claims to the SPV during securitisation.<sup>18</sup>

However, section 3:94 *BW* has been amended to include a provision that claims may also be transferred by means of an authentic or registered underhand deed without notifying the person against whom the right may be enforced of the transfer, provided that the claims exist at the time of the transfer or will be acquired directly from an existing legal relationship. Such a transfer cannot be relied upon against the person against whom the claims are enforceable, unless that person was notified of the transfer.<sup>19</sup>

South African law does not require notice to debtors for the validity of a cession of claims.<sup>20</sup> Furthermore, Dutch law is unfamiliar with the concept of a trust as it appears in the common law. In their exploration of the possibility of introducing something similar to a trust in Dutch law, academics have actually considered the South African example of the Trust Property Control Act.<sup>21</sup> Dutch law is therefore not helpful to a

<sup>16</sup> According to David G Glennie, Eduard C de Bouter & Radnall D Luke *Securitization* (1998) at 188 the lack of government credit enhancement of the kind provided in the United States of America (see par 4.1.1) and the strong financial position of Dutch banks are the main reasons for the unpopularity of securitisation in the Netherlands.

<sup>17</sup> Section 3:94 lid 1 *BW*; MHE Rongen “Securitisation en Vermogenafzondering van Vorderingsrechten op Naam” in SCJJ Kortmann, WAK Rank, MHE Rongen, G van Solinge & HLE Verhagen *Onderneming en Effecten* (1998) at 427 *et seq*; Gerard van Solinge “Afsplitsing van Vorderingen” in Kortmann *et al Onderneming en Effecten* at 468 *et seq*; WAK Rank *De (On)Hanteerbaarheid van het Nederlandse Recht voor de Moderne Financiële Praktijk: Beschouwingen over Sale and Lease Back, Leveraged Leasing, Repo's en Securitisation* (1998) at 39–41; Glennie *et al Securitization* at 121–122.

<sup>18</sup> Notice to debtors is time-consuming, administratively burdensome and expensive. Furthermore, notice may be confusing to debtors and might give a negative signal to the market about the originator's creditworthiness. See Van Solinge in Kortmann *et al Onderneming en Effecten* at 470.

<sup>19</sup> Scott 2006 *SA Merc LJ* at 399.

<sup>20</sup> See par 7.2.2.2.3.

<sup>21</sup> 57 of 1988. See HLE Verhagen “Trusts in the Civil Law: Making Use of the Experience of ‘Mixed’ Jurisdictions” (2000) 3 *European Review of Private Law* 477; Donovan WM Walters “The Trust Civil Law Jurisdictions: The Dutch Experience” (1999) 7 *J of Int Trust and Corporate Planning* at 153–155. On the lack of the trust in Dutch law generally, see BJMA Meester “De Trustee als Houder van Zekerheidsrechten” in DJ Hayton, SCJJ Kortmann, AJM Nuytinck, AVM Struycken & NED Faber *Vertrouwd met de Trust: Trust and Trust-Like Arrangements* (1996) at 395; SCJJ

study of trusts, which forms part of this thesis. I have therefore not included a separate comparative chapter on Dutch law.

The slow development of securitisation in German law is mainly attributed to the well-developed German mortgage bond market (*Pfandbriefmarkt*)<sup>22</sup> and the reservations of the Federal Banking Supervisory Authority about securitisation where the originator is a bank.<sup>23</sup> The Federal Banking Supervisory Authority finally announced in its Circular on the Sale of Customer Receivables in Connection with Asset-Backed Securities by German Credit Institutions<sup>24</sup> that it would not in future raise any objections to securitisations in which credit institutions were the originators, as long as the requirements of the Circular were met. The requirements of the Circular are very similar to the South African Securitisation Notices.<sup>25</sup>

There are similarities between the German law position in relation to securitisation and the position in South Africa. As in South African law, German law follows an abstract system of the transfer of rights, which means that it distinguishes between an obligatory agreement and a transfer agreement.<sup>26</sup> German law also does not require notice to the debtor for a valid cession. However, owing to the slow progress of securitisation for the reasons stated above, German law finds itself in the same exploratory phase of the law of securitisation as does South Africa.<sup>27</sup> It was therefore decided to focus in this thesis on jurisdictions where securitisation has evolved fully and is now well established.

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Kortmann "Past 'de Trust' in het Nederlandse Recht?" in Hayton *et al Vertrouwd met de Trust* at 169; David Hayton "The Development of the Trust Concept in Civil Law Jurisdictions" (2000) 8 *J of Int Trust can Corporate Planning* at 159.

<sup>22</sup> German mortgage bonds (*Pfandbriefe*) are fixed interest-bearing bonds secured by a pool of mortgages on German real estate. The *Pfandbriefe* are issued by specialised mortgage banks. See Glennie *et al Securitization* at 75.

<sup>23</sup> Glennie *et al Securitization* at 75.

<sup>24</sup> Issued by the *Bundesaufsichtsamt für das Kreditwesen*, 19 March 1997. See Glennie *et al Securitization* at 85–87; Alexander H Stopp "Asset-Backed Financing in Germany: Legal Concepts Affecting the Securitization of German Receivables" (1997) 4 *The Financier* 27.

<sup>25</sup> See pars 6.2.1, 6.2.3, 6.2.4 and 6.2.5.

<sup>26</sup> See par 7.2 for the position in South African law.

<sup>27</sup> German literature on securitisation also looks at the American example before examining aspects specific to German law. See, for instance, Andreas Willburger *Asset Backed Securities in Zivil- und Steuerrecht* (1997) at 14 *et seq*; Theodor Baums *Asset-Backed Finanzierungen im deutschen Wirtschaftsrecht* (1992).

### 1.2.2 Structuring of securitisation scheme

The form and function of a traditional securitisation scheme is more or less uniform worldwide. This thesis starts by setting out a typical structure.<sup>28</sup> The structure of a typical South African traditional securitisation scheme has never been researched in an academic contribution. While American and English models are used in South Africa to structure a typical scheme, the differences between the law in those jurisdictions and South African law must be kept in mind.

The use of debt to finance a business generally, and debentures as the specific instrument regulated by the Companies Act<sup>29</sup> for the purpose of acquiring debt financing, are discussed in a separate chapter.<sup>30</sup> Thereafter the forms of security available in South African law where the security objects are claims is discussed. These are general notarial bonds, pledge of claims and fiduciary security cession. Specific attention is paid to which of these forms can be used most effectively as security during the securitisation process.

### 1.2.3 Regulatory considerations

While there is no single piece of legislation that regulates securitisation in South Africa, several Acts and other legislative instruments have an impact on securitisation generally and on the structure of the scheme particularly. A discussion of traditional securitisation in South African law will not be complete without a consideration of these aspects.<sup>31</sup>

### 1.2.4 True sale and insolvency-remoteness

Owing to the abstract system of the transfer of rights, two agreements between the originator and the SPV are necessary when the claims are transferred.<sup>32</sup> The first is the obligatory agreement which, in the case of securitisation, will be a contract of sale. The second is the transfer agreement. Both delegation and cession as possible transfer methods are considered.

<sup>28</sup> Chapter 2.

<sup>29</sup> 61 of 1973.

<sup>30</sup> Chapter 5.

<sup>31</sup> Chapter 6.

<sup>32</sup> Chapter 7.

The transfer of security rights to the SPV when the principal debt is transferred during securitisation is explained. Owing to the abstract system of the transfer of rights, accessory real security rights do not automatically follow the secured claim to the cessionary.

The legal relationship between the servicer and the SPV is considered, because often the originator will continue to act as servicer in the collection of the securitised claims. It is therefore essential that the servicing agreement be well separated from the sale agreement, so that the continued involvement of the originator will not be considered as an indication that the transfer of the claims were not meant as a true sale.

Simulated transactions in South African law are discussed with a view to determining the likelihood that a sale of claims could be recharacterised by a South African court as a secured loan. Since there is no case law in South African law directly in point, particular attention is paid to the arguments that have emerged with regard to factoring.

Lastly, the provisions of South African insolvency law that could possibly be raised by a liquidator of an originator to impeach the sale of the claims to the SPV are set out.<sup>33</sup> These provisions are applied to securitisation in order to decide the likelihood of success of an application to impeach.

### **1.2.5 Aspects that fall outside study**

Apart from a brief discussion of the evolution of the government-sponsored enterprises in the United States of America,<sup>34</sup> and the few remarks in this introduction, this thesis does not contain a historical background as is the case with most law theses.

The potential cross-border nature of securitisation is very interesting and a factor that complicates the already-complicated nature of securitisation even more. This is a study on its own and therefore the assumption was made that the entire transaction occurs in South Africa.

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<sup>33</sup> Chapter 8.

<sup>34</sup> Paragraph 4.1.1.

Securitisation has implications for corporate taxation, but a discussion of these tax implications falls outside the scope of this thesis. However, the conclusions drawn from this thesis may assist future studies in the area of tax law.

Small and medium enterprises can make use of securitisation as a financing tool, with minor variations to the basic form discussed here.<sup>35</sup> I assumed that the originator was a large enterprise in order to narrow the scope of the discussion. Most conclusions would, however, also be applicable to the securitisation of the assets of small and medium enterprises.

The capital requirements of banks and the influence of securitisation on these requirements are not considered.<sup>36</sup> The focus is on aspects of traditional securitisation that are applicable to both bank and non-bank originators.

### 1.3 TERMINOLOGY

The following terms are frequently encountered when dealing with the topic of securitisation:

- The *originator* transfers the assets to the SPV. The originator need not be a company, but may also be a different business form or a natural person. The assumption is made that the originator is a company.
- The *special purpose vehicle (SPV)* is a company or a trust that purchases the assets from the originator and pays for the transaction through the issue of securities, usually debt instruments. Apart from outlining the main structures in which a trust SPV is used in other jurisdictions,<sup>37</sup> the trust as an SPV falls outside the scope of this discussion. In this thesis the SPV is a company.
- A *credit rating* is a formal evaluation of the credit quality of a debt instrument (a bond or a debenture) undertaken by an independent rating agency and usually expressed with a symbol such as AAA or Aaa. The most active *rating agencies* in securitisations are Moody's, Standard & Poor's and Fitch.
- *Credit enhancement* refers to various methods employed to divert some of the risk associated with the transferred assets away from the investors, thereby making the

<sup>35</sup> See The Task Group of the Policy Board for Financial Services and Regulation *Access to Finance in South Africa: A Supply-Side Regulatory Review* (2001) at ch 5 for a discussion of the use of securitisation as a means of obtaining finance for small and medium-sized enterprises.

<sup>36</sup> See in this regard Bank for International Settlements' Basel Committee on Banking Supervision *Consultative Document: Asset Securitisation* (2001).

<sup>37</sup> Paragraph 2.3.

securities issued by the SPV more attractive to investors. The various credit enhancement tools are interesting enough to be the topic of a thesis on their own, but I only give a brief overview of the methods used most frequently.<sup>38</sup>

- A *trustee* acts on behalf of the investors in the securities issued by the SPV (essentially a trustee for debenture-holders).
- The *servicer* is responsible for the collection of principal debt and interest payments derived from the pooled assets and the transfer of these amounts to the SPV.
- A *conduit* is an SPV that purchases pooled assets from several originators and issues securities on those assets.

‘Securitisation’, ‘securities’ and ‘security for a claim’ are very similar terms that are used often in this thesis and must be distinguished. ‘Securitisation’ is the process of financing explained above. ‘Securities’ as defined in section 1 of the Securities Services Act<sup>39</sup> are typically shares, stocks and depository receipts in public companies, debentures, bonds, notes and derivative instruments. ‘Security for a claim’ is granted to a creditor in order to strengthen the creditor’s right of recourse in the event of default by the debtor. The security objects in this thesis are the claims transferred to the SPV and they serve to secure the claims of the investors of the SPV.

## 1.4 CONCLUDING REMARKS

For many years only banks and building societies made use of securitisation schemes. Increasingly, other companies are becoming aware of the possible advantages that securitisation may offer compared to the use of traditional debt instruments. Very little research has been done in South African law on the use of loans to fulfil the

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<sup>38</sup> Paragraph 2.5.

<sup>39</sup> 36 of 2004: “‘**Securities**’: (a) means – (i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 45 of 2002); (ii) notes; (iii) derivative instruments; (iv) bonds; (v) debentures; (vi) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investments Schemes in terms of section 65 of that Act; (vii) units or any other form of participation in a collective investment scheme licenced or registered in a foreign country; (viii) instruments based on an index; (ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and (x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the *Gazette* to be a security for the purposes of this Act; (xi) rights in the securities referred to in subparagraphs (i) to (x); (b) excludes – (i) money market instruments except for the purposes of Chapter IV; and (ii) any security contemplated in paragraph (a) specified by the registrar by notice in the *Gazette*.”



capital requirements of companies. As far as I could ascertain, no research has as yet been done on the use of securitisation by companies other than banks in South African law. I trust that this work will be the first step in the further exploration of these topics.

The law is stated as it was on 30 September 2008.



## PART I

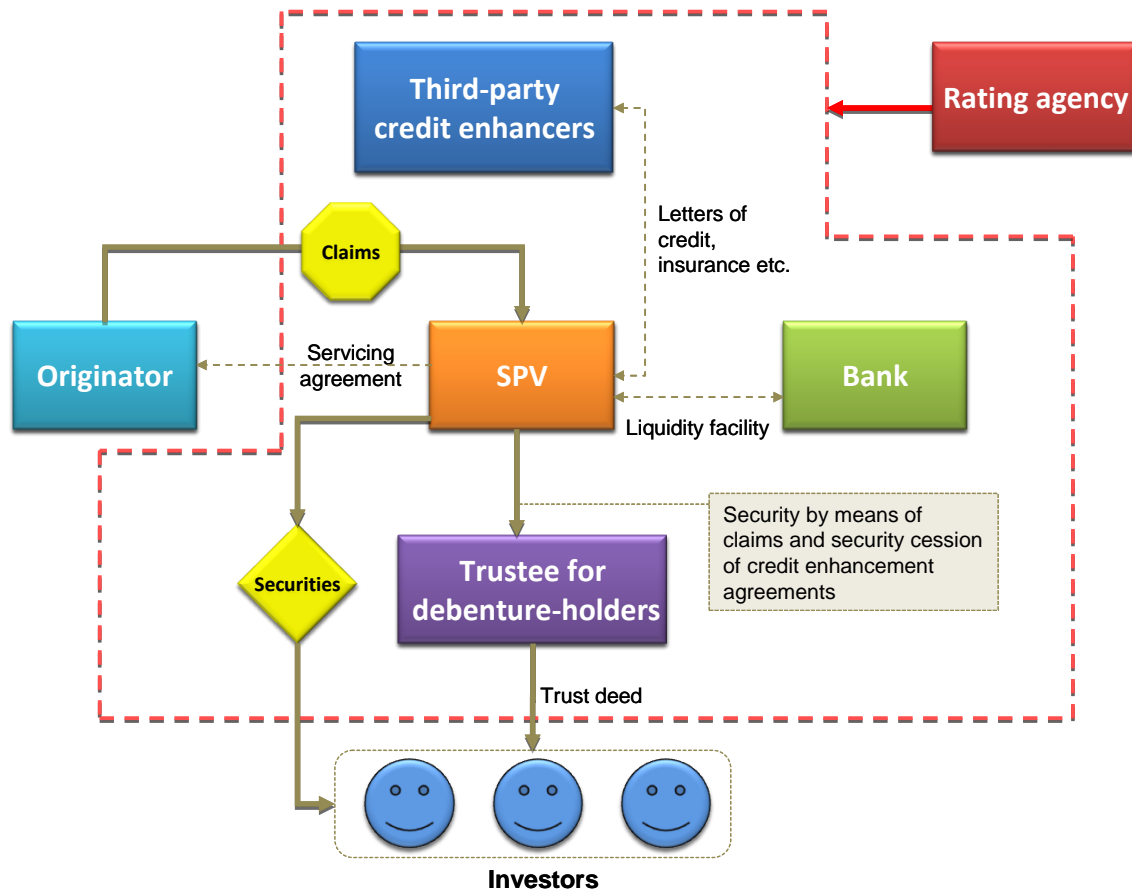
# TRADITIONAL SECURITISATION: GENERAL FORM AND FUNCTION



## CHAPTER 2 SECURITISATION: GENERAL FORM AND FUNCTION

### 2.1 INTRODUCTION

Certain definitions relating to securitisation were briefly explained in the introduction.<sup>1</sup> This chapter investigates the process of securitisation. A thorough understanding of this process is crucial.



**Figure 1: Simplified securitisation scheme**

Securitisation is the pooling of a homogenous group of income-producing assets, the sale of these assets by the original holder (originator) to an insolvency-remote third party (a special purpose vehicle (SPV)) and the issue by the SPV of marketable securities (commercial paper or other debt instruments)<sup>2</sup> to finance the purchase of the

<sup>1</sup> See par 1.3.

<sup>2</sup> See par 1 of the Schedule of Securitisation Notice, 2008: “commercial paper’ means – (a) any written acknowledgement of debt, irrespective of whether the maturity thereof is fixed or based on a notice period, and irrespective of whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; or (b) debentures or any interest-bearing written

assets.<sup>3</sup> The transferred assets provide the cash flow to service the obligations under the issued securities. The transferred assets, which in this discussion will be claims, are collected by a servicer at a fee. This function is often retained by the originator. The transferred assets further serve as security for the obligations of the SPV towards its investors. Usually a trustee holds this security on behalf of the investors. The transferred assets and the structure of the securitisation scheme are rated by a rating agency at a fee. Depending on the rating that is aimed for, the rating agency may recommend certain credit enhancements. These credit enhancements may be internal, that is, from the originator, or external from third parties. There may further be an underwriter for the issued securities. There will always be specialist opinions from accountants and lawyers. If the securities are offered to the public, there may be prospectus requirements and if the securities are to be traded on an exchange, the listing requirements of the particular exchange will apply. Securitisation is therefore an expensive and complicated undertaking.

## 2.2 ADVANTAGES OF SECURITISATION

It is possible in South African law for companies to raise loan capital directly in the form of debentures and to use their assets as security for the issued debentures.<sup>4</sup> Alternatively, South African companies have the option to use securitisation. A company will prefer securitisation if the benefits of securitisation outweigh those of traditional loan financing.<sup>5</sup> The most important advantages of securitisation are improved liquidity, a diversification of funding sources, the achievement of better interest rates, better risk management and certain accountancy-related advantages.<sup>6</sup>

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acknowledgement of debt issued for a fixed term in accordance with the provisions of the Companies Act; or (c) preference shares, but does not include bankers' acceptances." The SPV may only issue commercial paper in denominations equal to or greater than an initial principal value of R1 million, unless it is listed on a licenced financial exchange, endorsed by a bank, issued for longer than five years or backed by government guarantees. See par 14(1)(b)(i) of the Schedule of Securitisation Notice, 2008. The SPV must be authorised in writing by the Registrar of Banks to issue commercial paper. See par 14(1)(b) (ii) of the Schedule of Securitisation Notice, 2008.

<sup>3</sup> See the definition of 'traditional securitisation scheme' in par 1 of the Schedule of Securitisation Notice, 2008. See further Figure 1.

<sup>4</sup> See ch 5.

<sup>5</sup> According to Steven L Schwarcz "The Alchemy of Asset Securitization" (1994) 1 *Stanford Journal of Law, Business and Finance* at 137–138 a company considering securitisation should determine (a) the difference between interest payable on non-securitised financing and interest payable on the securities issued by the SPV, and (b) the expected difference in financing costs between traditional financing and financing through securitization.

<sup>6</sup> Tax benefits are not considered in this thesis.

However, from the outset it must be emphasised that these advantages are dependent on the success of the securitisation scheme, in terms of obtaining a good rating and guarding against the insolvency of the SPV. I also briefly discuss some non-rational reasons why some companies opt for securitisation.

### 2.2.1 Improved liquidity

Securitisation, by its nature, turns claims into cash.<sup>7</sup> The cash can be used by the company for a variety of purposes, including research and development, new projects and to meet its normal supplier obligations.

### 2.2.2 Diversification of funding sources

Investors who may ordinarily be reluctant to invest in the originator may be willing to invest in the securities issued by the SPV, because of the higher credit rating that securities issued by the SPV will achieve.<sup>8</sup> For instance, pension fund managers that might be willing to purchase the highly rated securities issued by the SPV, could be unwilling to purchase conventional debt securities of the originator.<sup>9</sup>

It may also be that previous financing arrangements between the originator and its creditors contained restrictions on further issues of long-term debt and that securitisation has become the only option.<sup>10</sup>

Diversification of funding sources may improve the originator's own credit rating, making it possible after securitisation to return to more traditional forms of financing.<sup>11</sup>

<sup>7</sup> Lupica "Asset Securitisation: The Unsecured Creditor's Perspective" (1998) 76 *Texas LR* at 609–610, Itzikowitz & Malan 1996 *SA Merc LJ* at 185; Phillip Wood *Project Finance, Securitizations, Subordinated Debt* 2 ed (2007) at 118; Glennie *et al Securitization* at 210; D Barbour, J Norton & T Slover *Asset Securitization in Emerging Market Economies: Fundamental Considerations* (1998) at 9.

<sup>8</sup> Schwarcz 1994 *Stanford J of Law, Business & Finance* at 143; Lupica 1998 *Texas LR* at 610; Joseph J Norton, Mitchell S Dupler & Paul R Spellman *International Asset Securitization* (1995) at 11; Fidelis Oditah *The Future for the Global Securities Market: Legal and Regulatory Aspects* (1996) at 92; Wood *Project Finance* at 118; Standard & Poors *Corporate Ratings Criteria* (2006) at 119. See also the discussion of rating agencies in par 2.6.

<sup>9</sup> Barbour *et al Securitization in Emerging Market* at 8–9.

<sup>10</sup> Lupica 1998 *Texas LR* at 610.

<sup>11</sup> Lupica 1998 *Texas LR* at 611; Wood *Project Finance* at 118.

### 2.2.3 Better interest rates

Rating agencies usually give securities issued by the SPV a higher credit rating than to securities issued directly by the originator.<sup>12</sup> The higher rating translates into a better interest rate.<sup>13</sup>

Smaller, less-established or financially weaker companies may be able to fund themselves through securitisation on similar terms to those offered to larger, better established and financially sound companies.<sup>14</sup> The savings generated by the lower interest rates obtained through securitisation can then be used by smaller companies to build their enterprises.<sup>15</sup>

### 2.2.4 Improved risk management

In traditional lending the lender bears the full burden of the risks associated with the business of the borrower. Lenders try to assess this risk with reference to the borrower's likelihood to default, the borrower's repayment capacity, credit record and its business prospects for the full term of the loan. This assessment may include ongoing monitoring of the business and practices of the borrower, which may be inconvenient for the borrower and lender alike.<sup>16</sup>

During securitisation the investor does not need to gauge the quality of the originator's business, but only needs to assess the quality of the assets backing the transaction.<sup>17</sup> Usually an originator will try to securitise its highest quality claims.<sup>18</sup>

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<sup>12</sup> See pars 2.2.4 and 2.6.

<sup>13</sup> Schwarcz 1994 *Stanford J of Law, Business & Finance* at 137; Lupica 1998 *Texas LR* at 614; Itzikowitz & Malan 1996 *SA Merc LJ* at 186; Wood *Title Finance* at 45; Glennie *et al Securitization* at 209; Barbour *et al Securitization in Emerging Market* at 9.

<sup>14</sup> According to Oditah *Global Securities Market* at 89, there will usually be a net saving even taking into account the high transaction costs involved in securitisation. Thomas J Gordon "Securitization of Executory Future Flows as Bankruptcy-Remote True Sales" (2000) 67 *University of Chicago LR* 1317 at 1321–1322 refers to the same advantage as a "lower discount rate". It amounts to this: the originator can get more for its assets through the medium of securitisation than it could via traditional lending. He sees this as the main reason why securitisation is an attractive financing option.

<sup>15</sup> On the use of securitisation to obtain funding for small and medium enterprises see The Task Group of the Policy Board for Financial Services and Regulation *Access to Finance in South Africa – A Supply-Side Regulatory Review* (2001).

<sup>16</sup> Schwarcz 1994 *Stanford J of Law, Business & Finance* at 150–151; Oditah *Global Securities Market* at 92–93.

<sup>17</sup> Lupica 1998 *Texas LR* at 611–612; Norton *et al Asset Securitization* at 11 and 13; Barbour *et al Securitization in Emerging Market* at 9.

<sup>18</sup> See par 2.4.



The securitisation will further contain risk-reducing measures, such as credit enhancement, where a third party undertakes to bear a part of the risk of default in exchange for a fee.<sup>19</sup> The originator's business behaviour and the risks associated with the business of the originator will not influence the quality of the securitised assets.

### 2.2.5 Accountancy-related advantages

The transfer of assets to the SPV will usually be considered a sale for accounting purposes if the transfer is made without recourse.<sup>20</sup> In other words, the sale must be made without undertakings from the originator to step in if the debtors default on the transferred claims or in other specified events.<sup>21</sup> This may benefit the originator in various respects. For instance, it may aid the originator in maintaining its capital adequacy requirements<sup>22</sup> or in maintaining the debt–equity ratios specified in previous loan agreements.<sup>23</sup> In South Africa the transfer must be without recourse to qualify for the exemption under the Banks Act.<sup>24</sup> This limitation does not exclude the giving of warranties by the originator in respect of the transferred assets, provided that those warranties relate neither to the creditworthiness of the originator nor to matters that fall outside the control of the originator.<sup>25</sup>

<sup>19</sup> See par 2.5.

<sup>20</sup> Norton *et al Asset Securitization* at 11.

<sup>21</sup> Steven L Schwarcz “Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures” (2002) 70 *University of Cincinnati LR* at 1315 shows that this was the main reason why the SPVs used in the Enron debacle failed; there was no real transfer of risk from the originator to the SPV.

<sup>22</sup> This is especially important in the financial (banking) sector and falls outside the scope of our discussion. See Itzikowitz & Malan 1996 *SA Merc LJ* at 186–187; Wood *Project Finance* at 117; Barbour *et al Securitization in Emerging Market* at 10. Paragraph 4(1)(d) of the Schedule of Securitisation Notice, 2004 states that “a bank that sells assets to a special purpose institution in terms of a traditional securitisation scheme may be allowed to exclude from the calculation of its required capital and reserve funds the assets so sold when the transfer constitutes, amongst other things, a ‘true sale’”. Reducing the capital requirements of banks will become a less important motivation for securitisation after implementation of Basel II in 2008, since the revised guidelines set by Basel II mean that most securitisations will still have to be reflected in the capital requirements of banks, albeit as a reduced risk exposure. However, securitisation will remain important to banks as an alternative funding source.

<sup>23</sup> See also Wood *Project Finance* at 117; Glennie *et al Securitization* at 210.

<sup>24</sup> 94 of 1990. See par 4(2)(c) of the Schedule of Securitisation Notice, 2008.

<sup>25</sup> Paragraph 4(2)(d) of the Schedule of Securitisation Notice, 2008.

## 2.2.6 Non-rational and illegal motivations

Theoretically, a company should opt for securitisation rather than conventional debt financing when the benefits of the former outweigh those of the latter. However, decisions are not always taken rationally. Opting for securitisation because it has become fashionable or to judgment-proof the company's operations is, in my opinion, not a rational motivation, unless some of the advantages discussed above also apply. Criminals could use the complicated nature of a securitisation scheme to commit fraud or money laundering.

### 2.2.6.1 Trends

Companies usually seek expert opinion from advisors such as law firms, investment banks and rating agencies on the best alternative to raise finance. In many cases advisors recommend the option with which they are most familiar and which may be most lucrative for them.<sup>26</sup>

Securitisation is a time-consuming and complex endeavour. This has caused many advisors who have successfully completed one securitisation utilising the expertise they have acquired in follow-up transactions.<sup>27</sup> It has also led originators to engage in repeat securitisations.<sup>28</sup>

### 2.2.6.2 Judgment-proofing

Some authors have explored the use of securitisation as a method of 'judgment-proofing' a company from its creditors.<sup>29</sup> A debtor is judgment-proof when the debtor

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<sup>26</sup> Lupica 1998 *Texas LR* at 606.

<sup>27</sup> Lupica 1998 *Texas LR* at 607.

<sup>28</sup> The European Securitisation Forum has an annual forecast of the volume of securities issued via securitisation schemes. The forecast for 2007 was an issuance volume of € 531 billion. The issuance volume for 2006 was € 456 billion, which means that an increase of 16, 4 per cent was expected for 2007. See European Securitisation Forum *Securitisation Market Outlook 2007*, available at [www.eurosecuritisation.com](http://www.eurosecuritisation.com) (accessed 24 October 2007). This shows the immense popularity of securitisation as a financing tool. It remains to be seen whether this popularity will endure after the current economic downturn.

<sup>29</sup> See Lynn M LoPucki "The Death of Liability" (1996) 106 *Yale LJ* 1 at 23–30; Lynn M LoPucki "The Essential Structure of Judgment Proofing" (1998) 51 *Stanford LR* 147 at 159; Steven L Schwarcz "The Inherent Irrationality of Judgment Proofing" (1999) 52 *Stanford LR* 1 at 13–15 and 17–28; Lynn M LoPucki "The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz" (1999) 52 *Stanford LR* 55 *et seq*; Steven L Schwarcz "Judgment Proofing: A Rejoinder" (1999) 52 *Stanford LR* at 77–79.

has no wealth or when its wealth is held in forms that make it unavailable to its creditors for attachment.<sup>30</sup>

Judgment-proofing generally is achieved by splitting a business into an asset-owning company and an operating company. The two companies are linked by contractual arrangements so that they function as one business. The judgment creditors of the operating company are not legally entitled to recover their judgments from the owning company. So while the operating company incurs all the risks associated with the business, all the assets are vested in the owning company. The former is merely an empty shell.<sup>31</sup>

It is possible to securitise almost any asset of a company.<sup>32</sup> Consequently, securitisation may be a means to effect such a judgment-proof structure.<sup>33</sup> However, even in economies where securitisation is much more common than in South Africa, securitisation is not often used as a means to judgment-proof a company.<sup>34</sup> It is therefore safe to assume that this will not often be the main motivation for securitisation in South Africa.

Though the scope of this discussion does not allow me to explore this question further, I would suggest that large South African companies that aim to dilute their liability would rather opt to use holding-subsidary structures in order to effect judgment-proofing.<sup>35</sup> South African courts have consistently been reluctant to

<sup>30</sup> LoPucki 1996 *Yale LJ* at 4.

<sup>31</sup> See LoPucki 1998 *Stanford LR* at 152–153 for the various methods in which this may be achieved.

<sup>32</sup> See par 2.4 below.

<sup>33</sup> LoPucki 1996 *Yale LJ* at 30 puts it as follows: “Asset securitization may be the silver bullet capable of killing liability.” In a later article he makes the valid point that, even if the ultimate purpose of a specific securitisation transaction was not to effect judgment-proofing, it is a result that will follow automatically (LoPucki 1999 *Stanford LR* at 59 and 61). See also Peterson 2007 *Cardozo LR* at 2269–2273 for a discussion of how the securitisation structure can shield the perpetrators of poor consumer credit practices from liability from consumers’ claims.

<sup>34</sup> LoPucki 1996 *Yale LJ* at 40 for the position in the United States of America. The author cites transaction costs, public relations considerations and social norms as the main reasons for the reluctance to judgment-proof a company (at 43–47; 51–54). See further Schwarcz 1999 *Stanford LR* at 48–50. The author does not agree that securitisation does or will play a great role in judgment-proofing (at 51). See further LoPucki 1999 *Stanford LR* 55 *et seq* for an answer to Schwarcz’s assertions and Schwarcz’s rejoinder at 77 *et seq*.

<sup>35</sup> See LoPucki 1996 *Yale LJ* at 20–23 for an explanation of this method of judgment-proofing. Schwarcz 1999 *Stanford LR* at 28–32 would classify this as non-arm’s length business transactions, where the different companies are fellow-subidiaries and their financial statements will be consolidated. Under these circumstances he expects a greater likelihood of judgment-proofing, than in arm’s length transactions such as securitisation.

disregard the separate legal personality of a company,<sup>36</sup> which means that the courts will generally uphold the separateness of a holding company and its subsidiaries.

### 2.2.6.3 Money laundering and fraud

There are criminal groups with enough money to set up paperwork so that a scheme of securitisation may seem legitimate, when, in fact, it serves to turn an illegal stream of income into legal funding. All that is needed is to set up an originator that appears to be legitimate.<sup>37</sup>

It is also possible to use securitisation and other forms of structured finance for other fraudulent purposes.<sup>38</sup> However, it would be incorrect to suggest that securitisation is synonymous with such practices.<sup>39</sup> Although some of the fraudulent practices involving SPVs, as in the case of Enron, have received much publicity, they make up a very small percentage of securitisation transactions. These instances do show, however, that the complexity of securitisation may necessitate better disclosure to the investors in the originators and the SPVs, as well as measures to avoid conflicts of interests.<sup>40</sup>

<sup>36</sup> *Salomon v Salomon & Co Ltd* [1897] AC 22; *Dadoo v Krugersdorp Municipal Council* 1920 AD 530. In *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 (4) SA 790 (A) the Court held that the previous criterion set in *Botha v Van Niekerk* 1983 (3) SA 513 (W) that the conduct must lead to some “unconscionable injustice” was too narrow a view. The Court held that each case must be considered on its own. The need to preserve the separate corporate identity of the company will then be balanced against the policy considerations in favour of piercing the veil (at 803H). In *Hülse-Reuter v Gödde* 2001 (4) SA 1336 (SCA) at 1346A–D the Court held that: “the separate legal personality of a company is to be recognised and upheld except in the most unusual circumstances”. The courts do not have a general discretion to disregard the separate legal personality of the company. There must be some misuse or abuse of the separate legal personality of the company from its controllers that must lead to the latter receiving some unfair advantage. See further JB Cilliers & SM Luiz “The Corporate Veil: An Unnecessary Confining Corset? (1996) 59 *THRHR* at 527.

<sup>37</sup> Andrew Haynes “Legal Developments in Debt Securitisation” (2000) *European Business LR* 39 at 41–42.

<sup>38</sup> See for instance Schwarcz 2002 *University of Cincinnati LR* at 1309. In Enron’s case, some of the SPVs were owned by Enron’s chief financial officer, who used the complicated nature of the schemes to hide the fact, first, that he was pocketing some money and, second, that the projected incomes securitised to the SPV’s never actually materialised.

<sup>39</sup> Schwarcz 1999 *Stanford LR* at 78: “The possible misuse of a beneficial tool should not undermine its legitimacy.”

<sup>40</sup> Schwarcz 2002 *University of Cincinnati LR* at 1316–1318. See further Steven L Schwarcz “Securitization Post-Enron” (2004) 25 *Cardozo LR* at 1551–1553 for a description of how the special purpose vehicles were misused by the Enron group as opposed to the legitimate use of such vehicles during securitisation.

## 2.3 SPECIAL PURPOSE VEHICLE (SPV)

A trust could act as the SPV in securitisations.<sup>41</sup> In the United States of America and in England the trust SPV is used, although the corporation SPV is used more often.<sup>42</sup> The main reason for this is that the trust SPV cannot provide the accounting, tax and insolvency benefits that a corporation SPV could.<sup>43</sup> I shall briefly explain the main forms in which a trust is used as an SPV in the United States of America and in England and then I shall indicate why I prefer the use of the SPV in the form of a company.

The following schemes make use of a trust SPV:<sup>44</sup>

- The SPV could take the form of a non-taxable grantor trust.<sup>45</sup> This structure is referred to as a 'pass-through transaction'.<sup>46</sup> The grantor trust SPV grants certificates to its investors and the investors receive an interest in the pool of assets held by the trust. The powers of the trustee are limited and he is not typically allowed to purchase new assets or substitute them, or to reinvest money held by the trust. This usually means that money received from the income on the assets will be distributed to the investors immediately. A grantor trust may only issue one class of beneficial interest, otherwise it will lose its grantor trust status. It may, however, issue two classes of beneficial interest if the only distinction is that the second class is subordinate to payments from the first.
- A pay-through transaction refers to the private or public issuance of asset-backed bonds from a special purpose corporation or from an owner trust. The trustee in this trust must manage the cash flow generated by the assets to match it with the obligations on the securities issued. It will therefore not qualify as a grantor trust and will be taxable. To avoid the separate taxability of the SPV, it usually remains under the control of the originator. The SPV and the originator will file consolidated tax returns so that the originator may offset any losses in its business

<sup>41</sup> See, for instance, Phillip Wood *Title Finance, Derivatives, Securitizations, Set-off and Netting* (1995) at 46–47. Securitisation Notice, 2008 makes express provision for an SPV in the form of a company or a trust.

<sup>42</sup> See Patrick D Dolan & C Vanleer Davis *Securitizations: Legal and Regulatory Issues* (2002) at 2-8.

<sup>43</sup> Dolan & Davis *Securitizations* at 20-16.

<sup>44</sup> Norton *et al Asset Securitization* at 8–10.

<sup>45</sup> See also Dolan & Davis *Securitizations* at 2-8.

<sup>46</sup> According to Norton *et al Asset Securitization*, at 60, the pass-through structure would be considered a collective investment scheme under English law, which makes it a less suitable form for the SPV.

against the tax liability of the SPV. The originator and the SPV will further issue consolidated financial statements. This structure does not have limitations in terms of issuance as does the pass-through structure, but the business of the originator and the SPV will not be at arm's length, which could pose a risk to the insolvency-remoteness of the SPV.

- In a master trust transaction the originator sells the assets to a trust. The trust could access several investor markets and does so by the issuance of different series of securities. Since the trustee must manage cash flow to match the dates of maturity of the different series, it will not qualify as a grantor trust and will be taxable. It is therefore structured so that the securities issued by the SPV are considered debt of the originator for tax purposes. This structure is therefore also not beneficial for the insolvency-remoteness of the SPV.

South African law has never received the English law of trusts.<sup>47</sup> It is possible to be appointed as a trustee by the Master of the High Court in terms of the Trust Property Control Act.<sup>48</sup> Appointment under the provisions of the Act will ensure that the trust property is not considered part of the trustee's personal estate. The Act further provides a measure of protection to the beneficiaries under the trust.<sup>49</sup>

It must be borne in mind that South African law does not benefit from centuries of precedent and evolution of the trust concept as does English law. I therefore consider the SPV in the form of a company to be a more certain method of achieving the goals of securitisation in South African law. As my brief discussion above shows, the special purpose company is better suited to achieve insolvency-remoteness in terms of creating a definite divide between the originator and the SPV. The SPV in the form of a company is the only type of SPV that has issued asset-backed securities on the Bond Exchange of South Africa,<sup>50</sup> which shows that it is preferred when the securities are issued to the public. The rest of my discussion will therefore focus on the use of a company as an SPV.<sup>51</sup>

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<sup>47</sup> See n 296 below.

<sup>48</sup> 57 of 1988.

<sup>49</sup> See the discussion in par 2.8.2.1.2

<sup>50</sup> See the bond history available at [www.bondexchange.co.za](http://www.bondexchange.co.za) (accessed 26 October 2007).

<sup>51</sup> Securitisation Notice, 2008 makes express provision for both forms of SPV.

### 2.3.1 Capitalisation

An SPV may be a subsidiary of the originator formed for the exclusive purpose of the securitisation.<sup>52</sup> This method is usually followed in the United States of America. Alternatively, the shares in the SPV can be held by a third party, for instance a trust,<sup>53</sup> which eliminates the need to include the SPV in the consolidated balance sheet of the originator.<sup>54</sup> This is the preferred method in England.<sup>55</sup>

In South Africa the SPV will not be exempt from compliance with the Banks Act<sup>56</sup> if the originator, acting on its own or in collaboration with associated companies, directly or indirectly, holds more than 20 per cent of the nominal value of the share capital of the SPV.<sup>57</sup> The originator must further not have the right to determine the outcome of voting at a general meeting of the SPV. This means that the SPV may not be a subsidiary of the originator in South African law.<sup>58</sup>

Another option is to use a multi-seller vehicle, sometimes referred to as a ‘conduit’.<sup>59</sup> A conduit is created to purchase and fund claims portfolios from several originators. Conduits are not subsidiaries of the originators, which enhances their

<sup>52</sup> Lupica 1998 *Texas LR* at 605; Glennie *et al Securitization* at 207.

<sup>53</sup> This is the method preferred by the rating agencies. It is not clear for whose benefit the trustees will hold the shares in the SPV. It cannot be for the benefit of the originator, since the scheme will then not comply with the terms of Securitisation Notice, 2008. Section 1(3)(c) of the Companies Act 61 of 1973 provides that “a body corporate or other undertaking which would have been a subsidiary of a company had the body corporate or other undertaking been a company shall be deemed to be a subsidiary of that company”. The trust will therefore be considered a subsidiary of the originator if it is the major beneficiary under the trust deed or when the originator may appoint most of the trustees of the owner trust. If the trust is a subsidiary of the originator the SPV will also be a subsidiary, because the trust will hold all the shares in the SPV. Furthermore, even if the trust has beneficiaries, there will be little or no benefits accruing to those beneficiaries, since the SPV is not aimed at making a profit for its shareholders but solely at performing on its issued debt securities. It seems to me that this is not really a trust within the South African legal context, but rather a nominee shareholder with a level of independence from the originator, so that it cannot be said that the originator controls the decisions of the nominee.

<sup>54</sup> Wood *Title Finance* at 41, 46; Glennie *et al Securitization* at 194.

<sup>55</sup> This is sometimes referred to as an ‘orphaned’ SPV, because the beneficial ownership of the SPV is vested in a management company that specialises in this business or by a charitable trust. Such a structure increases the remoteness from the originator and will attain a better rating. See Report by Fitch Ratings “Structured Finance Criteria Report: Special-Purpose Vehicles in Structured Finance Transactions” 13 June 2006 at 2 available at [www.fitchratings.com](http://www.fitchratings.com).

<sup>56</sup> 94 of 1990.

<sup>57</sup> Paragraph 4(2)(p)(i) of the Schedule of Securitisation Notice, 2008. In terms of par 2(1) the securitisation scheme will not be seen as an activity that falls within the meaning of ‘the business of a bank’ if these and other requirements discussed below are met.

<sup>58</sup> For the definition of ‘subsidiary’, see s 1(3)(a) of the Companies Act 61 of 1973.

<sup>59</sup> See Barbour *et al Securitization in Emerging Market* at 14; Schwarcz 1994 *Stanford J of Law, Business & Finance* at 140–141.

insolvency-remote status. Since the structure of a conduit is already in place, a smaller company could securitise some of its assets more cheaply and with greater ease through a conduit than to set up a securitisation scheme of its own. Often such conduits are subsidiaries of the investment bank or underwriter involved in the scheme.<sup>60</sup> However, multi-seller vehicles must ensure that the different asset pools and cash flow from these pools are legally separated from each other.<sup>61</sup> Otherwise there may be the danger that the liabilities flowing from one issuance of securities backed by a certain pool of assets may attach to another pool of assets. The effectiveness of this segregation will be considered by the rating agency. The rating agency will further evaluate whether the structure of the conduit provides for the separate enforcement of the security provided for the issued securities of the different asset pools. Apart from this distinction, conduits function more or less in the same manner as an SPV set up for a single transaction.

Generally, the SPV will be thinly capitalised to ensure that there is zero taxable income for tax purposes.<sup>62</sup> The SPV does not rely on share capital for the fulfilment of its goals, but on the income generated from the transferred claims and on the loan capital acquired through the issued securities.

The SPV may be a public or a private company. The SPV in the form of a private company will work well for most securitisations, since the SPV typically does not have many shareholders. Private companies are also subject to fewer reporting requirements.<sup>63</sup>

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<sup>60</sup> Securities issued by conduits are seldom listed on an exchange, because an investment bank in control of a conduit usually has the expertise and client base to match borrowers and lenders. It follows that such securities are often privately placed.

<sup>61</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 3.

<sup>62</sup> In other words, there will be no substantial share capital. See Michael S Gambro & Michael A McCormack "Legal Considerations in Structuring Asset-Backed Securities in the US Market" *Global Securitisation and Structured Finance* (2005) at 4, Oditah *Global Securities Market* at 85; Wood *Title Finance* at 41.

<sup>63</sup> Private companies do not need to draw up half-yearly interim reports on the business and operations of the company (s 303 of the Companies Act 61 of 1973) and do not need to provide a copy of their annual financial statements to the Registrar of Companies, unless they are subsidiaries of a public company (s 302(4) of the Companies Act 61 of 1973). In terms of clause 30(1)(b)(ii) of the Companies Bill 61 of 2008 a private company does not need to prepare annual financial statements if one person holds all the securities issued in that company or has all of the beneficial interest in that company. It is further unnecessary for a private company to prepare annual financial statements in terms of this clause if every person who holds securities in the company or beneficial interests in the company is also a director of the company. In terms of clause 34(2) of the Companies Bill a private company is not required to comply with the extended accountability requirements set out in chapter 3 of the Bill. These requirements include the appointment of company secretaries and more involvement by the company auditors and the audit committee of the board of directors.



### 2.3.2 Corporate governance

Securitisation Notice, 2008 provides that the board of directors of the SPV must be independent from the originator if it wants to be exempted from falling within the meaning of ‘the business of a bank’.<sup>64</sup> The originator may validly appoint one director of the SPV as long as a minimum of three directors have been appointed on the board.<sup>65</sup>

Whatever the composition of the board, its powers should be restricted to the management of the securitisation scheme. Any transaction outside the collection of cash flow from the asset pool, distribution of payments to investors and the payment of fees to third parties involved in the scheme should only be possible with consent from the investors. In view of such restrictions, the appointment of a trustee for debenture-holders will greatly assist the management of the SPV.<sup>66</sup>

The traditional view is that directors owe their duties to the company.<sup>67</sup> The directors are not obligated to act in the best interests of individual members or creditors.<sup>68</sup> However, since the company is a metaphysical entity,<sup>69</sup> it has been held that “the company as a whole” refers to the body of shareholders.<sup>70</sup> This position does not hold true for the SPV during securitisation.<sup>71</sup>

<sup>64</sup> Paragraph 4(2)(q) of the Schedule of Securitisation Notice, 2008.

<sup>65</sup> Paragraph 4(2)(m)(i) of the Schedule of Securitisation Notice, 2008.

<sup>66</sup> See par 2.8.3 below.

<sup>67</sup> Cilliers *et al Corporate Law* at 139; PM Meskin, B Galgut, Jennifer A Kunst, Piet Delport & Quintus Vorster *Henochsberg on the Companies Act* (2008) at 394; *SA Fabrics Ltd v Millman NO* 1972 (4) SA 592 (A) at 596E–F; *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd* 2006 (5) SA 333 (W) at 350H–I: “This is the fundamental duty which qualifies the exercise of any powers which the directors in fact have. The ‘interests’ in this context, are only those of the company itself as corporate entity and those of its members as a body.” See also Sulette Lombard *Directors’ Duties to Creditors* (2006 thesis UP) at 292, where she cites *In re Smith & Fawcett* [1942] Ch 304 at 306.

<sup>68</sup> *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563; *Percival v Wright* [1902] 2 Ch 421 at 425–426.

<sup>69</sup> Lombard *Duties to Creditors* at 293.

<sup>70</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] 1 Ch 286. See Cilliers *et al Corporate Law* at 149; LS Sealy “Directors’ ‘Wider’ Responsibilities – Problems Conceptual, Practical and Procedural” (1987) *Monash University LR* 164 at 165; Irene-Marie Esser “The Enlightened-Shareholder-Value Approach Versus Plurism in the Management of Companies” (2005) *Obiter* 719; Lombard *Duties to Creditors* at 293.

<sup>71</sup> See also Michael J Cohn “Asset Securitization: How Remote is Bankruptcy Remote?” (1998) 26 *Hofstra LR* 929 at 947–949, who shares this view. A particular problem in the context of securitisation is that the structure of the SPV is set up so that an application for insolvent liquidation can only be made in the interests of the investors. However, a shareholder may argue that liquidation

The shareholders of an SPV will never receive dividends, because all income generated from the collection of the claims is used to pay the interest and capital on the issued securities. Any excess is usually diverted to a reserve fund for future payments in terms of the debt securities. At the dissolution of the SPV, the remaining assets will either revert to the originator or will be passed on to some charitable purpose, in terms of the transaction agreements. It cannot be said that the shareholders are the end beneficiaries of the duties of the SPV's directors. During the existence of the SPV the investors, who are usually creditors, are the only beneficiaries of the business of the SPV.

Managing the affairs of a company in favour of its creditors is not the norm in South African law.<sup>72</sup> In other jurisdictions where the courts have tried to introduce a duty towards creditors under certain circumstances,<sup>73</sup> these attempts have been met with mixed reaction.<sup>74</sup> I do not foresee such an interpretation of directors' duties in the

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is in the members' best interests, which by current standards would be the more important concern, and that the SPV must apply for voluntary liquidation.

<sup>72</sup> See Derek Botha "Directors' Fiduciary Duties to Bondholders? Some Relationships Between Corporate Financial Management and Fiduciary Law" (1993) 5 *SA Merc LJ* 287; OJS Fourie "Die Plig van Direkteure teenoor Maatskappyskuldeisers" (1992) 2 *SA Merc LJ* 25; MK Havenga "Directors' Fiduciary Duties Under Our Future Company Law Regime" (1997) 9 *SA Merc LJ* 310; JJ du Plessis "Direkteure se Pligte teenoor Partye anders as die Maatskappy" (1992) *De Jure* 378 at 387–391; Meskin *et al Henochsberg* at 395.

<sup>73</sup> Notably during the insolvency or nearing insolvency of the company: see *Kinsela v Russell Kinsela (Pty) Ltd* (1986) 10 ALR 395 SC (NSW) at 404; *Nicholson v Permacraft (NZ) Ltd* (1985) 1 NZLR 242 CA at 249; *In re Horsley & Weight Ltd* [1982] 1 Ch 442 at 255; *Grove v Flavel* (1986) 43 SASR 410 at 421; *West Mercia Safetywear v Dodd* [1988] BCLC 250 (CA) at 252. See further *Walker v Wimbourne* (1976) 137 CLR 1 HC of A at 7; *Spies v The Queen* (2000) 201 CLR 603 HC of A at 554–555; *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627 (HL) at 634F. In the USA, the decision *Credit Lyonnais Bank Nederland, NV v Pathe Communications Co* No. CIV A 12130, 1991 Del Ch LEXIS 215 (Dec 30, 1991), *aff'd* No CIV A 12150, 1996 Del Ch LEXIS 157 (Dec 20, 1996) held that a board of directors owes its duty to the corporate enterprise when the corporation is nearing insolvency, and that the board acts as an agent of the residual risk bearers (at 108–109). The use of insolvency or nearing insolvency to indicate that a duty exists toward creditors is not sufficient in the case of an SPV during securitisation. First, the SPV is insulated from insolvency as far as possible. Second, the interests of the creditors are paramount from the very beginning, due to the fact that they contribute all of the capital of the SPV.

<sup>74</sup> Sealy 1987 *Monash Univ LR* 164; DD Prentice "Creditors' Interests and Directors' Duties" (1990) 10 *Oxford Journal of Legal Studies* 265; David A Wishart "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand LR* 323; James McConvill "Directors' Duties to Creditors in Australia after *Spies v The Queen*" (2002) 20 *Company and Securities LJ* 4; Robert Dean Ellis "Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights" (1999) 24 *J of Corporation Law* at 312–318.

case of an SPV implemented by South African courts without legislative intervention.<sup>75</sup>

### 2.3.3 Insulating SPV against insolvency

The SPV must be set up in such a manner that it will be most unlikely that it would become insolvent.<sup>76</sup> This is also referred to as ‘making the SPV insolvency-remote’. The constitutive documents of the company play an important role in this regard.

The capacity of a company is set out in the objects clause of its memorandum of association. In an SPV set up for use in a securitisation scheme, these objects must be strictly limited to activities related to the transaction.<sup>77</sup> In terms of paragraph 2(1)(c) of Securitisation Notice, 2008, the exemption of the SPV of engaging in the business of a bank is dependent on its not entering into any transactions outside the securitisation scheme. Put differently: if the SPV engages in business outside the securitisation scheme, it will be regarded as a bank and would have to comply with the provisions of the Banks Act.<sup>78</sup>

The capacity of the SPV must at least include the ability to purchase claims from the originator. The objectives of the SPV must further be wide enough so that it will have the legal capacity to issue securities, pay the servicer and the providers of credit enhancement facilities and create security in favour of the trustee for debenture-holders.

The constitutive documents must also prohibit the merger of the SPV with a company that does not adopt similar limitations in its constitutive documents.<sup>79</sup> This implies that the SPV may only merge with a conduit.<sup>80</sup>

<sup>75</sup> See also the concluding remarks of Lombard *Duties to Creditors* at 395–408 and Natania Locke *Fiduciary Duties Towards Creditors* (Unpublished paper delivered at the Southern African Law Teachers’ Association Conference, July 2003).

<sup>76</sup> Schwarcz 1994 *Stanford J of Law, Business & Finance* at 135–136; Thomas J Gordon “Securitization of Executory Future Flows as Bankruptcy-Remote True Sales” (2000) 67 *University of Chicago LR* at 1324; Glennie *et al Securitization* at 206; Report by Fitch Ratings Report by Fitch Ratings *Structured Finance Criteria Report: Special-Purpose Vehicles in Structured Finance Transactions* 13 June 2006 at 1, available at [www.fitchratings.com](http://www.fitchratings.com).

<sup>77</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 4.

<sup>78</sup> 94 of 1990. The Act sets onerous reporting standards and states certain capital adequacy requirements. See further par 6.2.5.

<sup>79</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 4.

<sup>80</sup> Gordon 2000 *University of Chicago LR* at 1325.

The amendment of the constitutive documents should not be possible without a sizeable proportion of the investors' consent. It should not be possible for the members of the SPV to amend the restriction on the capacity of the SPV without such consent.<sup>81</sup>

The securitisation scheme will receive a better rating if the SPV is newly formed for the purpose of the securitisation, because there will be no prior creditors that may increase its chances of insolvency.<sup>82</sup> If the SPV is not newly formed, the rating agency will require extensive information on the past liabilities of the SPV, its business transactions and any factors that may convince the agency not to lower the rating of the securities.

Since all the parties involved in the securitisation scheme are known, it is possible to require that they all contractually agree not to lodge an application for the winding-up of the SPV because it is unable to pay its debts.<sup>83</sup> Usually the servicer, liquidity provider and the providers of credit enhancement agree not to institute an application for winding-up until two years after final payment of the securities issued by the SPV.<sup>84</sup> The risk of such an application will be further limited if a trustee is appointed for the debenture-holders, so that only he may institute action on their behalf. This reduces the risk that any individual investor may apply for winding-up when it will not be in the interests of the majority of the investors.<sup>85</sup>

In the United States there is a risk that a court may invalidate agreements not to launch bankruptcy proceedings, because of public policy against bankruptcy waivers.<sup>86</sup> However, the aim of the typical restrictions on filing for bankruptcy contained in the setting up of an SPV is not to prevent the bankruptcy of the SPV in all instances, but only where such filing will not serve the interests of the investors.<sup>87</sup>

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<sup>81</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 4.

<sup>82</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 2.

<sup>83</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 4–5. Fitch analysts expect such agreements and require detailed explanations if it cannot be validly concluded in the relevant jurisdiction. In South African law an agreement not to institute proceedings before a specified date is referred to as a *pactum de non petendo*. See *Total South Africa (Pty) Ltd v Bekker NO* 1992 (2) SA 617 (A) at 626F–G; AJ Kerr *The Principles of the Law of Contract* (2002) at 653.

<sup>84</sup> Norton *et al Asset Securitization* at 15. In South Africa the inclusion of non-petition clauses has led to the insistence of the transaction creditors of the issuer SPV to be secured. This, in turn, has led to the use of a security SPV as discussed in par 2.8.2.1.

<sup>85</sup> See par 2.8.3 below.

<sup>86</sup> Cohn 1998 *Hofstra LR* at 950; Ellis 1999 *J of Corporation Law* at 307.

<sup>87</sup> Cohn 1998 *Hofstra LR* at 951; Ellis 1999 *J of Corporation Law* at 307–308.

The board of directors of the SPVs in the United States are usually made up of at least one independent director, who is obliged to act in the interests of the investors rather than in the interests of the shareholders of the SPV.<sup>88</sup> The constitutive documents of the SPV then provide that a voluntary petition for bankruptcy may only be made by the SPV after the unanimous consent of the directors has been obtained.

The only risk that the investors in the securities must bear in relation to the transaction is that the debtors may default on their claims. This risk is quantified for investors in the form of a credit rating provided by a credit rating agency.<sup>89</sup>

## 2.4 IDENTIFICATION AND TRANSFER OF APPROPRIATE ASSETS TO SPV

It is possible to securitise any kind of asset, as long as that asset provides a steady flow of income that can be used to fulfil the obligations arising from the debt securities issued by the SPV. The following are the securities issued against the different asset types most commonly securitised:<sup>90</sup>

- *Residential mortgage-backed securities*: these are securities that are backed by mortgages granted by financial institutions to consumers. Securitisation had its origin in the need for greater liquidity in the residential housing market in the United States of America.<sup>91</sup> This asset type is therefore the one longest in use for securitisation.
- *Commercial mortgage-backed securities*: these are securities backed by mortgages granted by financial institutions to property developers and companies for the development of properties that will be used for commercial purposes, such as shopping malls and business blocks. The debtor is usually a company or another business entity, which distinguishes this asset type from residential mortgages.
- *Asset-backed securities*: these are securities backed by claims that are not secured by mortgages. There is a further distinction between ‘consumer asset-backed securities’ and ‘commercial asset-backed securities’:

<sup>88</sup> In the USA the originator is often the sole shareholder of the SPV. See Cohn 1998 *Hofstra LR* at 947–949.

<sup>89</sup> See par 2.6 below.

<sup>90</sup> Wood *Project Finance* at 113; Glennie *et al Securitization* at 195, 205.

<sup>91</sup> See par 4.1.

- *Consumer asset-backed securities* are backed by pools of claims where the debtors are general consumers. Examples are: personal loans, credit card claims, vehicle finance, television rentals, health care claims and telephone charges. This form of asset-backed security has seen remarkable growth during the last decade.
- *Commercial asset-backed securities* are backed by pools of claims where the debtors are businesses, in other words, one business grants credit to another business. The most typical examples are equipment leases and 30 to 90-day trade obligations.
- *Collateralised debt obligations*: simply put, these are securitisations of securities issued through other securitisations or of debt securities issued by companies. Securities issued to several investors are purchased from those investors by an SPV, which pools the securities and issues securities backed by that pool. The debtors are the SPVs of the original securitisation transactions or the companies that issued the debt securities.<sup>92</sup>
- *Whole business securitisations*: securities may also be backed by an entire business. An originator will identify a part of its business to transfer to the SPV, or may choose to securitise its entire current business portfolio. Typical examples of whole business securitisations are: film revenue securitisations, music royalty securitisations, pharmaceutical patent securitisations and trademark licensing revenue securitisations. The continued success of the originator typically remains important for a successful whole business securitisation. Consequently, rating agencies keep the corporate business risk of the originator in mind when rating these securities. Of particular importance is the ability of a third party to continue collection of the income generated by the transferred business in the event of the originator's liquidation. The continued relationship between the originator/servicer and the SPV after securitisation might put stress on the true sale test of the assets in the event of the originator's insolvency. It is important that the transaction be structured in such a manner that the originator will retain the ability to generate income outside the securitised business. In such a case the

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<sup>92</sup> On collateralised debt obligations in general see Dolan & Davis *Securizations* ch 9.

recharacterisation of the transaction as a secured loan will be less likely.<sup>93</sup> There has not as yet been a whole business securitisation in South Africa.

All of the above asset types consist of claims in one form or another, although whole business securitisation will usually include a few other asset types, especially intellectual property rights. In order to limit the scope of my discussion, I shall not discuss whole business securitisations in any further detail, although many of my later comments may be of use to such transactions. My focus is on a securitisation of a pool of claims and their accessory rights.

One needs to bear the following in mind when deciding on which claims to transfer to the SPV:<sup>94</sup>

- *Collectibility*: what are the chances that the debtor will default? An extensive payment history with regard to the particular type of asset may be helpful.<sup>95</sup>
- *The standardisation of the documentation of the claims*: the transferability of the claims may depend on the terms of the agreement between the originator and the debtor. Claims that result from standardised agreements are cheaper and safer to securitise.
- *The life of the claim*: here one should not only consider the dates of maturity of the claims, but also the tendency among debtors of that particular kind of claim to prepay the debt. Trade receivables usually have a life of 30 days, whereas motor vehicle loans are usually repaid over five years. It is preferable that the principal debt will be fully paid at maturity of the claim.<sup>96</sup>
- *Simplicity*: if the claim is the result of a very complicated transaction between the originator and the debtor, it is probably not suitable for securitisation.

<sup>93</sup> On whole business securitisations in general see Report by Standard & Poor's *US Corporate Securitization Transactions* 24 October 2006, available at [www. Standardandpoors .com/ ratingsdirect](http://www.Standardandpoors.com/ratingsdirect), (accessed 1 November 2007).

<sup>94</sup> Wood *Project Finance* at 115–116; Barbour *et al Securitization in Emerging Market* at 18–19; Norton *et al Asset Securitization* at 11.

<sup>95</sup> See Thomas W Albrecht & Sarah J Smith "Corporate Loan Securitization: Selected Legal and Regulatory Issues" (1998) 8 *Duke J of Comp & Int L* at 425–428 on the practices of 'cherry picking' and 'lemon selling'. The former term refers to when an originator only selects its best performing assets to securitise, and the latter means that the originator chooses its highest risk assets to securitise.

<sup>96</sup> This is referred to as 'amortising maturity' as opposed to 'balloon maturity', whereby the borrower pays a disproportionately large payment at the end of the loan period rather than in smaller equal amounts. See Barbour *et al Securitization in Emerging Market* at 19–20.

- *Geographic and demographic diversity*: it is preferable that the assets do not all originate from the same area; otherwise an economic slump may affect the collection of the claims. If geographic diversity is impossible, which is often the case in small countries, the emphasis should be on demographic diversity.

Usually only claims that require no further performance from the originator will be transferred to the SPV.<sup>97</sup> In terms of paragraph 4(2)(a) of Securitisation Notice, 2008<sup>98</sup> a ‘true sale’ will follow if all rights *and obligations* originating from the underlying transactions are transferred to the SPV. I discuss the transfer of the assets in detail in Chapter 7.

## 2.5 CREDIT ENHANCEMENT

The claims transferred to the SPV must be sufficient to cover all payments due to the investors. Any potential shortfalls or mismatches in dates of maturity are usually covered by various credit enhancement mechanisms.<sup>99</sup> If a third party provides the credit enhancement, the third party must have a high credit rating; at least as high as the rating of the securities of the SPV.<sup>100</sup>

The claims may be sold at a discount to absorb the risk that some of the claims may remain uncollected. This will already enhance the credit rating of the SPV.<sup>101</sup> Alternatively, the originator may sell more claims to the SPV than is needed to service the issued securities. This is referred to as ‘overcollateralisation’.<sup>102</sup> The originator may also stipulate a deferred sale price, for example, 80 per cent of the purchase price is paid immediately and the other 20 per cent when the claims are collected. Overcollateralisation may assist the SPV in paying for the start-up fees of the securitisation scheme<sup>103</sup> and it may also serve purely as a credit enhancement.

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<sup>97</sup> Calvin Reis-Roy “Rating Securitisation Structures” (1998) 13 *Journal of International Banking Law* at 299.

<sup>98</sup> GN 2, GG 30628 (1 January 2008).

<sup>99</sup> On credit enhancement in general see Barbour *et al Securitization in Emerging Market* at 16–17.

<sup>100</sup> Wood *Title Finance* at 58; Glennie *et al Securitization* at 196.

<sup>101</sup> Wood *Title Finance* at 51.

<sup>102</sup> Wood *Project Finance* at 153; Schwarcz 1994 *Stanford J of Law, Business & Finance* at 141–142.

<sup>103</sup> For instance, servicing fees, fees for the rating agency, lawyers, accountants, credit enhancers, insurance premiums etc.



Investors also carry the risk of prepayment, in other words, that the debtors of the transferred claims pay the debt before maturity. The interest obtainable from investing such income until the maturity of the issued securities will probably be lower than the interest that the debtor would have had to pay if he did not repay the debt earlier.<sup>104</sup> Credit enhancement might aim to remedy such a situation, especially by way of overcollateralisation.<sup>105</sup>

Usually the transferred claims will bear a higher interest rate than the debt securities issued to finance the transaction. However, it might be that the claims have a fixed interest rate, whereas the securities have a floating interest rate, or the other way round. In such a situation the SPV may enter into an interest swap with a third party so that the third party pays any shortfall that may arise.<sup>106</sup>

Some of the credit risk may be spread through a two-tier issue of securities. Here class B securities are subordinated to class A securities. If there is a larger default rate than expected, or poor liquidity due to late payments or large-scale prepayments, the class A securities will be paid first and the class B securities will only receive payment from any remaining funds. The holder of the class B securities, which may be either the originator or a third party, agrees to bear the greater risk in return for a higher yield.<sup>107</sup>

The SPV may create a reserve account where any surplus amount originating from the difference between the interest on the securities and the interest payable on the debts are kept.<sup>108</sup> The money may then be applied towards any of the risk events discussed.

Lastly, guarantees such as letters-of-credit may be provided by third parties in the event of the non-performance by the debtors of the claims.<sup>109</sup> Insurance resorts under this form of credit enhancement.

<sup>104</sup> See Wood *Title Finance* at 48–49.

<sup>105</sup> Reis-Roy 1998 *J of Int Banking Law* at 301. Historical data will give the rating agency a good indication of the risk of prepayment, which may lead it to recommend a form of credit enhancement. See also par 2.6 below.

<sup>106</sup> An interest swap is a contract in terms of which each party agrees to make periodic payments to the other equal to interest on an agreed principal amount, but the interest is calculated on a different basis. For a full discussion of interest swaps see Wood *Title Finance* at 212–213.

<sup>107</sup> Wood *Project Finance* at 153; Glennie *et al Securitization* at 197; Reis-Roy 1998 *J of Int Banking Law* at 301; Schwarcz 1994 *Stanford J of Law, Business & Finance* at 143.

<sup>108</sup> Wood *Project Finance* at 153; Glennie *et al Securitization* at 197.

<sup>109</sup> Wood *Project Finance* at 152.

There may also be a liquidity support agreement between the SPV and a third party, usually a bank. This provides for the situation where the timetable of the collection of the claims transferred to the SPV is disrupted, which results in the inability of the SPV to honour one of its payments to the investors.<sup>110</sup> This arrangement will only cater for short-term mismatches and is not considered a credit enhancement.<sup>111</sup>

The investors ultimately carry the risk of non-collection, which is the risk estimated by the rating agency.

## 2.6 RATING AGENCIES

Rating agencies are private companies that have gained widespread acceptance in the investment community.<sup>112</sup> The largest three rating agencies worldwide are Standard and Poor's Ratings Group, Moody's Investor's Service and Fitch Investor Service.<sup>113</sup> Their role in the success of the securitisation scheme is extremely important, since investors rely on the rating provided when deciding to invest in a particular scheme. One author refers to rating agencies as "the universally feared gatekeepers for the issuance and trading of debt securities".<sup>114</sup>

A credit rating is an opinion on the ability of an entity or of a securities issue to meet its financial commitments on a timely basis.<sup>115</sup> A credit rating is also an indication to investors of the extent of the risk of their investment.<sup>116</sup> The investment mandates of most fund managers in South Africa require the use of credit ratings.<sup>117</sup> A rating must usually be of a prescribed investment grade before the fund manager will

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<sup>110</sup> Wood *Project Finance* at 152; Glennie *et al Securitization* at 197.

<sup>111</sup> 'Liquidity facility' in terms of par 1 of the Schedule of Securitisation Notice, 2008 does not carry the meaning of a credit enhancement. The provider of the liquidity facility only provides a short-term facility to the SPV until its income stabilises, after which the SPV will refund the liquidity provider with any payments made in terms of the facility.

<sup>112</sup> Barbour *et al Securitization in Emerging Market* at 7.

<sup>113</sup> See [www.standardsandpoors.com](http://www.standardsandpoors.com) ; [www.moodys.com](http://www.moodys.com) and [www.fitchratings.com](http://www.fitchratings.com) (accessed 26 July 2007).

<sup>114</sup> See Steven L Schwarcz "Private Ordering of Public Markets: The Rating Agency Paradox" (2002) *Univ of Illinois LR* at 2.

<sup>115</sup> The review by Fitch Ratings in *Profile's Financial Markets Handbook* (2006) at 282.

<sup>116</sup> See Reis-Roy 1998 *J of Int Banking Law* at 298.

<sup>117</sup> The review of Moody's in *Profile 2006* at 319–320.

be allowed to invest.<sup>118</sup> This means that in the opinion of a rating agency there is only a small risk of default on the issued securities.

### 2.6.1 Factors considered when rating securitisation

Rating agencies set stringent requirements for a high rating which, in turn, affects the structure of the scheme.<sup>119</sup> Most of the credit enhancements discussed in the previous paragraph will be employed in order to achieve a better rating.

A rating will be done both initially and periodically.<sup>120</sup> Agencies further aim to provide a rating that is internationally consistent, regardless of differences in the law.<sup>121</sup>

A rating agency will investigate and test the risks associated with two aspects of the securitisation scheme, namely (1) the risks associated with the assets and (2) the risks associated with the structure of the scheme.<sup>122</sup>

The quality of the assets (claims) is determined by the likelihood of default by the debtors.<sup>123</sup> This will, in turn, determine the level of credit enhancement needed to achieve the rating envisioned. During this analysis the ingredients of the asset pool and the risks associated with them are identified.<sup>124</sup> They are then subjected to testing scenarios. Risks may include the insolvency of the debtor, default by the debtor, prepayment of the debt and fluctuations in interest rates. Historical data will help analysts determine the performance pattern of the asset pool under normal economic conditions. For instance, historical data may show that five per cent of debtors of the particular asset pool default. Depending on the rating aimed for, the analysts may

<sup>118</sup> 'Investment grade' is a term originally used by various regulatory bodies in the USA to indicate debt securities that are eligible for investment by institutions such as banks, insurance companies and savings and loan associations (pension funds). See Schwarcz 2002 *Univ of Illinois LR* at 7–8.

<sup>119</sup> Wood *Title Finance* at 60–61.

<sup>120</sup> There is a strong emphasis on continuous monitoring of the rating in the USA. See Annette L Nazareth *NRSRO Proposal Opening Statement at March 3, 2005 Open Commission Meeting*, available at [www.sec.gov/news/speech/spch030305aln.htm](http://www.sec.gov/news/speech/spch030305aln.htm) (accessed 22 July 2007).

<sup>121</sup> Schwarcz 2002 *Univ Illinois LR* at 8. However, a company's securities' rating will usually be capped by the sovereign rating received by the country in which the company is based. This might be a problem for a company that would otherwise receive a good rating, but is based in a country known for political or financial instability.

<sup>122</sup> Reis-Roy 1998 *J of Int Banking Law* at 299.

<sup>123</sup> Glennie *et al Securitization* at 209.

<sup>124</sup> Reis-Roy 1998 *J of Int Banking Law* at 300–301.

multiply that five per cent by several factors. If the asset pool will still manage to service the obligations under the issued securities, it shows that the rating is accurate.

The structural analysis is shaped to suit the asset pool.<sup>125</sup> A rating agency will determine the insolvency-remoteness of the SPV, the insolvency insulation of the SPV, the quality of the credit enhancement<sup>126</sup> and of the systems for administration of the servicer.<sup>127</sup> If the securitisation scheme runs across borders, a rating agency will also take into account the sovereign ratings of the countries involved, as well as, for example, the ratings of the holding bank if it works through a branch in the issuing country.<sup>128</sup>

The scheme will only receive a credit rating if the rating agency is satisfied that the transaction will be considered a true sale of the claims and that the claims cannot be construed as part of the originator's estate on the latter's insolvency.<sup>129</sup>

The process of obtaining a credit rating is both time-consuming and costly.<sup>130</sup>

## 2.6.2 Regulation of rating agencies

Rating agencies play such an important role in securitisation and in the issuance of debt securities in general that one may consider regulating them.<sup>131</sup> In the United

<sup>125</sup> Reis-Roy 1998 *J of Int Banking Law* at 301.

<sup>126</sup> Including the credit rating of the third party credit enhancers.

<sup>127</sup> An inexperienced or under-capitalised servicer may be required by the rating agency to engage a back-up or standby servicer. See Barbour *et al Securitization in Emerging Market* at 20. To guard against the risk that the assets of the servicer and the receipts from the claims of the SPV mingle, the servicer will make use of a 'lockbox' account. The servicer deposits the receipts into this account as soon as they are received. It may make deposits but has no powers to make withdrawals from that account. The account is cleared daily to the SPV's account. See Reis-Roy 1998 *J of Int Banking Law* at 302.

<sup>128</sup> Reis-Roy 1998 *J of Int Banking Law* at 302–303.

<sup>129</sup> Schwarcz 2002 *Univ Illinois LR* at 19; Barbour *et al Securitization in Emerging Market* at 31; Report by Fitch Ratings *Special-Purpose Vehicles* at 2: "The Fitch analyst is concerned primarily with the certainty with which the assets have been isolated from the corporate credit risk. The means of achieving this may vary between jurisdictions, asset classes and structures." See further at 5–6.

<sup>130</sup> Glennie *et al Securitization* at 192, 221.

<sup>131</sup> See Steven L Schwarcz *Statement to the US Securities and Exchange Commission: Hearing on Credit Rating Agencies* 8 November 2002; Schwarcz 2002 *Univ Illinois LR* at 12–20. Regulation may be further divided into extensive intervention to improve performance and limit potentially negative consequences, or limited governmental control by giving official recognition to rating agencies that meet certain criteria. See Schwarcz 2002 *Univ Illinois LR* at 4 and 11. The latter form of regulation is the one favoured by Schwarcz (at 21–23). It is currently the one used in the USA, where the Securities and Exchange Commission (SEC) uses the term Nationally Recognised Statistical Rating Organization (NRSRO) in the Exchange Act Rule 3b-10 to connote whether an agency's ratings may be relied upon for purposes of the federal securities law and rules. See in this regard Nazareth *Opening Statement*. The official recognition approach has now been elaborated on with the recently adopted Credit Rating Agency Reform Act of 2006 (S. 3850 – 190<sup>th</sup> Congress). See

States of America rating agencies are regulated by securities law, because the rating agencies serve the same purpose as securities regulation, namely to minimise the potential harm that information asymmetry may cause in the markets.<sup>132</sup> In other words, the objective of both ratings and securities regulation is to ensure that the investor has access to sufficient information to make informed decisions.

Regulation should only be considered if it can make the system more efficient.<sup>133</sup> The intrinsic costs associated with regulation must be offset by this efficiency gain.<sup>134</sup>

Several factors are important when considering whether it is necessary to regulate rating agencies. Some commentators argue that the business of rating agencies ought to be open for public scrutiny before they will be truly accountable.<sup>135</sup> However, the agencies have a strong incentive to provide accurate ratings, because their business is dependent on their good reputation.<sup>136</sup> If an agency consistently provides inaccurate ratings, lenders will cease to pay any attention to the rating and the business of the agency will suffer.

The cost of rating is high, but not necessarily excessive.<sup>137</sup> The agencies require a large number of highly skilled staff members to make informed assessments. The costs are further determined by the size of the transaction and its complexity. In the case of securitisation, each transaction requires a fresh investigation into the quality of the securitised assets and the transaction is by its nature complicated. There may also be fees for continued monitoring. Even if regulation could decrease these fees, such savings might be offset by the costs of the regulation itself.<sup>138</sup>

Then there is a potential conflict of interest arising from the fact that the issuer of the securities usually pays the rating fee, while a third party relies on the information.<sup>139</sup> This may be an incentive for a rating agency to give a higher rating. However, the rating fee is usually negotiated before the service is rendered and the

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further Natania Locke "The Role of Rating Agencies During a Securitisation Scheme" 2008 *De Jure* 545 where I argue that a similar form of regulation might be beneficial in South Africa.

<sup>132</sup> Schwarcz 2002 *Univ Illinois LR* at 10.

<sup>133</sup> Schwarcz 2002 *Univ Illinois LR* at 11.

<sup>134</sup> *Ibid.*

<sup>135</sup> Schwarcz *Statement* at 3.

<sup>136</sup> Schwarcz *Statement* at 2.

<sup>137</sup> Schwarcz 2002 *Univ Illinois LR* at 12.

<sup>138</sup> Schwarcz 2002 *Univ Illinois LR* at 13.

<sup>139</sup> Schwarcz *Statement* at 4.

reputational incentive discussed above still applies. The rating agencies further separate that division of their business that negotiates the fees from the one that is involved in the analysis during the rating process, to try and guard against conflict of interests. Furthermore, there are few alternatives to letting the issuer pay for the rating.<sup>140</sup> It is very difficult to get investors to pay for this service before they invest.

There have been cases where ratings were done without the consent of the issuer. Such ratings are referred to as ‘unsolicited ratings’ or ‘ratings without request’.<sup>141</sup> In response to some negative sentiment expressed to this practice, rating agencies now clearly indicate when an opinion on a securities issue was expressed without a request from the issuer.<sup>142</sup> It seems that the risk to the rating agencies’ reputation was enough to rectify this behaviour.

### 2.6.3 Liability towards third parties

A last question is to whom a rating agency owes its duty not to make misrepresentations in its rating. A rating agency is in a similar situation with respect to the SPV and the investors as the auditor of a company. An auditor is paid by the client company, but third parties regularly rely on the auditor’s opinion in their dealings with the company.<sup>143</sup> An auditor’s liability towards such third parties is based on delict.<sup>144</sup> Auditors are regulated by the Companies Act<sup>145</sup> and by the Auditing Profession Act.<sup>146</sup>

I suggest that, despite the above-mentioned similarity between rating agencies and auditors, extensive regulation of rating agencies is unnecessary. Liability towards

<sup>140</sup> Schwarcz 2002 *Univ Illinois LR* at 15–16.

<sup>141</sup> Moody’s Investor Service have subsequently defended unsolicited ratings as a method to guard against rating shopping. Rating shopping is where an issuer searches for the agency that will give its securities the highest rating. See Schwarcz 2002 *Univ Illinois LR* at 17–18.

<sup>142</sup> Schwarcz 2002 *Univ Illinois LR* at 17.

<sup>143</sup> On auditors see generally JT Pretorius, PADelport, Michele Havenga & Maria Vermaas *Hahlo’s South African Company Law through the Cases* 6 ed (1999) at 478–479; Cilliers *et al Corporate Law* at 395–430.

<sup>144</sup> *International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A) at 684H–685C. South African law differs in this regard to English law. The House of Lords held that auditors owed no duty of care to members of the general public who rely upon the accounts in deciding to buy shares in the company (*Caparo Industries plc v Dickman, Dickman and Touche Ross and Company* [1990] 2 WLR 358 (HL) at 370B, 375C, 394G–395A, 406A–F.) See further Cilliers *et al Corporate Law* at 424–426; Pretorius *et al Hahlo’s* at 480.

<sup>145</sup> 61 of 1973, ss 300–301.

<sup>146</sup> 26 of 2005, ss 46(3)(a) and (b). These provisions were taken over from the Public Accountants’ and Auditors’ Act 80 of 1991 (ss 20(9)(b)(i) and (ii)) despite some criticism.

third parties, which will normally be the investors, will follow under the appropriate circumstances in accordance with the principles of the law of delict. All the elements of a delict, namely conduct, wrongfulness, fault, factual and legal causality, and damage will have to be proved by the third party.<sup>147</sup>

Conduct can be either an act or an omission. A third party must prove that the rating agency misrepresented the risk of default of the securities issued by the SPV. Usually by the time legal action is taken by a third party, it will be certain that the rating awarded by the rating agency was inaccurate or misleading.

Wrongfulness will be more difficult to prove. The third party must prove that the rating agency's conduct was unreasonable "according to the legal convictions or feelings of the community".<sup>148</sup> Since a third party's claim will be one for damages for pure economic loss, it will have to be established that the rating agency was under a legal duty to guard against the third party's loss. The court will consider whether such a duty exists under the particular circumstances. The third party will probably raise the fact that, even though the SPV pays for the services of the rating agency, a rating is specifically aimed at aiding investors in their decision whether to invest in the securities issued by the SPV. In fact, certain institutional investors are obliged by their investment mandates only to purchase securities of a specific rating.

In contrast, it is a standard practice for rating agencies to qualify their rating by adding a disclaimer that a rating is an expression of a rating agency's opinion rather than a fact.<sup>149</sup> Oditah<sup>150</sup> argues that rating agencies represent themselves as being experts and that their opinion should indeed be held as fact. I agree with this view and I am further of the opinion that most investors rely on the opinion of rating agencies as if it were a fact. Rating agencies must foresee that the investors will rely on their opinion. Consequently, I believe that a legal duty does rest with rating agencies to provide an accurate rating to investors, thereby protecting them against loss.

<sup>147</sup> On the law of delict generally see J Neethling, JM Potgieter and PJ Visser *Law of Delict* 5 ed (2006).

<sup>148</sup> *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 (4) SA 371 (D) at 380E. This remains the position regardless of whether the wrongfulness lies in an infringement of a subjective right or in a breach of a duty of care.

<sup>149</sup> See for instance *Profile's 2006* at 282: "Credit and other ratings are not recommendations to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of any payments of any security."

<sup>150</sup> Oditah *Global Securities Market* at 86.

To my mind the elements that will probably be the most difficult to prove are fault and legal causality. Fault can be either intent or negligence, but it is highly unlikely that a rating agency will intentionally award an inaccurate rating. I foresee that a third party will mostly try to prove that the rating agency was negligent when it awarded the particular rating. Evidence will be led on whether the rating agency followed its standard procedures and methods during its consideration of the scheme. A substantial divergence from these methods and procedures may lead to a conclusion of negligence. However, no obligation rests on a rating agency to verify information supplied to it by the issuer SPV.<sup>151</sup> The rating agencies mostly rely on information given to them by issuers.<sup>152</sup> If the inaccurate rating followed because of incorrect information supplied by the SPV, there will not be a finding of negligence.

Factual causality will be relatively easy to prove. A third-party investor will have to prove that he relied on a rating provided by an agency in his decision to invest. In most cases the rating will be a factor that an investor considers when taking an investment decision. However, it will be very difficult for a third party to prove legal causality. Legal causality is determined by asking whether “the wrongful act is linked sufficiently closely or directly to the loss for legal liability to ensue or whether, as it is said, the loss is too remote”.<sup>153</sup> The investors in securitisation schemes are usually sophisticated, wealthy private investors or institutional investors. Consequently, it will be hard to prove that they were misled by a misrepresentation, regardless of whether the misrepresentation came from a reputable rating agency. Most investors of this type do not deal in securities solely based on ratings, but use internal analysis to reach their investment decisions.

Lastly, if the third party succeeded in proving all of the above elements, it will have to show that it suffered damage. Assuming that the third party can prove its

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<sup>151</sup> A rating does not make provision for the detection of fraud, nor can it be seriously contended that a rating agency should be responsible for the possible fraud of the originator and/or other parties to the transaction. This is contrary to the position relating to auditors. The Auditing Profession Act 26 of 2005 requires auditors to inform the Independent Regulatory Board for Auditors if they are satisfied or have reason to believe that a ‘reportable irregularity’ has taken place or is taking place in a company (s 45). A ‘reportable irregularity’ includes fraudulent acts or omissions (per the definition in s 1).

<sup>152</sup> See Schwarcz 2002 *Univ Illinois LR* at 6. In *Administrateur, Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A) at 831H–833B the AD confirmed the possibility of delictual liability for pure economic loss based on negligent misrepresentation. According to Cilliers *et al Corporate Law* at 423 the precise extent of such liability is not yet defined, but the possibility of such liability is no longer in doubt.

<sup>153</sup> *International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A) at 700I.



damage, I suggest that it will often be possible for a rating agency to prove contributory negligence on the part of a third party investor when that investor is a sophisticated or an institutional investor. Damages will then be apportioned accordingly.<sup>154</sup>

The short analysis above shows that liability towards third parties is a possibility. However, I do not think such action will be instituted often. Rating agencies tend to give conservative ratings because of concerns over liability and loss to reputation if they prove to be wrong.<sup>155</sup> They are further hesitant to downgrade a rating, for fear that it might give a negative signal that would cause a self-fulfilling prophecy: the downgrading of the rating causes the market to react negatively and the value of the securities drops.

## 2.7 SERVICER

The servicer is responsible for the collection of the principal debt and interest payments deriving from the pooled assets and the transfer of these amounts to the trustee, or to the SPV, depending on the structure of the scheme. The servicer may also be entrusted with the enforcement of the claims.<sup>156</sup> The originator often acts as the servicer.

The transaction agreements usually provide that the servicer must report regularly on the state of its collection of the claims to the SPV and to the trustee. Unless the transaction agreements specifically state otherwise, the trustee will have no duty to ensure the reliability of these reports.<sup>157</sup>

The servicer must clearly separate the income collected from the assets of the SPV from the collections in its own business. Failure by the servicer to keep to this obligation and the mingling of the SPV income with its own has jeopardised securitisations in the past.<sup>158</sup>

<sup>154</sup> In terms of the Apportionment of Damages Act 34 of 1956 a court may reduce the damages awarded to a plaintiff in delictual proceedings to the extent in which the plaintiff's negligence contributed to his loss.

<sup>155</sup> Schwarcz *Statement* at 3 and 4; Schwarcz 2002 *Univ Illinois LR* at 18.

<sup>156</sup> This aspect will be considered further in ch 7.

<sup>157</sup> See Sheila D Gibson "The Case for the Expanded Role of Trustees in Securitizations" (2004) 121 *The Banking LJ* at 403, where she argues that any added responsibility on the part of trustees must be negotiated early in the securitisation process, so that their fees can reflect the added burden and so that they may be fully acquainted with the transaction documents.

<sup>158</sup> See Gibson 2004 *Banking LJ* at 397–402 for some case studies.

In the event that the servicer defaults and is removed, the transaction agreements usually provide that the trustee is responsible for finding and appointing a successor servicer or that the trustee must provide these services.<sup>159</sup> Sometimes the trustee will be sophisticated and capable enough to take over such functions, but usually the administrative and skills burden will be so great that it would not be practical. If this is the case, an independent back-up servicer may be appointed.<sup>160</sup>

The back-up servicer will receive a fee to remain available to take over the servicing duties.<sup>161</sup> This will raise the costs of the transaction, but will provide certainty that the claims will still be collected in the event of the servicer's default.<sup>162</sup>

However, it may be difficult to find a back-up servicer that will be able to service the transferred assets at the same cost as the originator/servicer, especially if those assets are closely associated with the business of the originator. The risk of default of the servicer will further be accentuated if the transaction has a revolving character; in other words, new claims are continually transferred to the SPV. Under such circumstances the rating agency will have to evaluate the financial stability and history of the originator/servicer very carefully.<sup>163</sup>

## **2.8 SECURITY IN FAVOUR OF TRUSTEE FOR DEBENTURE-HOLDERS**

In a debenture trust, security is held for the benefit of a number of lenders. This is sometimes referred to as a 'collective security arrangement',<sup>164</sup> but I shall refer to it throughout as a 'trust for debenture-holders'. The latter term is used in the Companies Act<sup>165</sup> and it also excludes consideration of the position relating to syndicated loans.

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<sup>159</sup> Gibson 2004 *Banking LJ* at 390.

<sup>160</sup> Gibson 2004 *Banking LJ* at 391.

<sup>161</sup> The back-up servicer will need to be continually assessed to ensure that it is ready to take over the servicing if needs be. See Gibson 2004 *Banking LJ* at 407.

<sup>162</sup> Gibson 2004 *Banking LJ* at 407 states that servicing transfers carries a risk of higher default by the debtors. The author does not cite specific authority for this view, but it seems that she draws this conclusion from the case studies in her article.

<sup>163</sup> Gibson 2004 *Banking LJ* at 406.

<sup>164</sup> See the excellent comparative thesis on the subject by Angélique Thiele *Collective Security Arrangements: A Comparative Study of Dutch, English and German Law* (2003). See also Scott 2006 *SA Merc LJ* at 397.

<sup>165</sup> 61 of 1973. See below.

The use of a trust for debenture-holders during an issue of debt securities is beneficial for a number of reasons:

- When there are many debenture-holders it may be difficult for the SPV to effect any changes to the terms of the debentures or to modify or dispose of some of the security without the consent of all the debenture-holders. The trust for debenture-holders aims to ease these difficulties.<sup>166</sup>
- A trust for debenture-holders removes the need for each debenture-holder to monitor the security, but instead, places this duty on the trustee, who is usually a professional person or institution and better equipped to judge the safety of the investment.
- Where the type of security must be registered, as in the case of a general notarial bond, the use of a trust for debenture-holders saves costs and administrative burden. The security is registered in the name of the trust or in the name of the trustees for the time being.<sup>167</sup> There is no need to re-register the security in the names of the new debenture-holders when debentures are sold.<sup>168</sup>
- A trust for debenture-holders saves costs for both the debenture-holders and the SPV when the security has to be realised, because proceedings are taken in one action.
- Depending on the legal form of the trust,<sup>169</sup> the trustee may be in a stronger bargaining position than individual debenture-holders. When the trustee also has the right to enforce the claims of the collective debenture-holders, he is in a powerful position to address any failure by the SPV and of the servicer to comply with their contractual obligations.
- The trustee can continuously monitor the issuer SPV and the value of the security, whereas the debenture-holders will often fluctuate.

<sup>166</sup> Basil Wunsch "Trusts in Practice" in NJ Wiechers & Anneliese Roos *Trusts: Proceedings of a Seminar Presented by the Department of Private Law of the University of South Africa on 12 June 1992* (1993) at 68; Patrick O'Hagan "The Use of Trusts in Finance Structures" (2000) 8 *J of Int Trust and Corporate Planning* at 93; Christopher Duffett "Using Trusts in International Finance and Commercial Transactions" (1992) 1 *J of Int Planning* at 25; Geoffrey Fuller *Corporate Borrowing: Law and Practice* (1995) at 117–119.

<sup>167</sup> On the difficulties in this regard in the South African law, see par 5.5.1.

<sup>168</sup> See Thiele *Collective Security Arrangements* at 5 and 22; Philip Rawlings "The Changing Role of the Trustee in International Bond Issues" (2007) *J of Business Law* 43 at 47.

<sup>169</sup> See the discussion in par 2.8.2.1 *et seq.*

- Lastly, the debenture trust can be a mechanism by means of which it is ensured that the security is only enforced when it is in the best interests of all of the debenture-holders.<sup>170</sup>

The legal form of the trust for debenture-holders in South African law is uncertain. I approach the legal form of a trust for debenture-holders from the point of view that the best form will be the one that delivers most of the above-mentioned benefits, while complying with the legal requirements for the creation of a trust. A further important consideration in deciding what legal form a trust for debenture-holders takes is that there must be compliance with the accessory nature of the security granted in favour of the trustee.

### 2.8.1 Form of security

Securities are issued by the SPV to finance the purchase of the assets, in this case, claims from the originator. Usually these securities will be debt instruments such as debentures. These debentures are, in turn, secured by assets of the SPV.

The assets available for the SPV to serve as security are the transferred claims, as well as any claims in terms of the credit enhancement agreements, the servicing agreement and the shares in the SPV.<sup>171</sup> Under current South African law there are two possibilities to secure the claims of the debentures-holders, namely (1) a general notarial bond or (2) a cession *in securitatem debiti*.<sup>172</sup> Cession in *securitatem debiti* can either take the form of a pledge of claims or of a fiduciary security cession.<sup>173</sup> The form of security will influence the rating of the scheme by the rating agency.<sup>174</sup>

It must be remembered that the whole aim of the securitisation scheme is to insulate the claims from the potential insolvency of the originator and to guard, as far

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<sup>170</sup> Thiele *Collective Security Arrangements* at 6 and 20. Rawlings 2007 *JBL* at 46–47 shows that debenture-holders may have rational motivations why they want to accelerate performance of the debenture to the prejudice of the other debenture-holders.

<sup>171</sup> The shares in the SPV are pledged to ensure that any residual value in the SPV serves as security for the claims in favour of the investors. However, the value of this shareholding should be negligible under normal circumstances.

<sup>172</sup> See ch 5 for a detailed discussion of these forms of security.

<sup>173</sup> See par 5.4.3.

<sup>174</sup> The rating agencies will usually require a third party legal opinion on the perfection and priority of the security granted to the trustee for debenture-holders. See Glennie *et al Securitization* at 223; Report by Fitch Ratings *Special-Purpose Vehicles* at 4 and 5.

as possible, against the insolvency of the SPV. Security in favour of the debenture-holders is only one aspect of this greater goal.

### 2.8.2 Security structures

In the United States of America and in England a trust for debenture-holders is used to achieve the goals listed in paragraph 2.8. South African securitisation transactions have not made use of a trust, but have opted for the use of a security SPV. The security SPV is usually a company.

The practice of using a security SPV arose from the opinion of the rating agencies that the trust for debenture-holders as described in the Companies Act<sup>175</sup> cannot secure the claims of creditors other than the debenture-holders.<sup>176</sup> Section 117 of the Companies Act provides that security for debentures may be granted in favour of a trustee for debenture-holders.<sup>177</sup> No mention is made of the possibility that such security may also secure the claims of creditors other than the debenture-holders.

I am of the opinion that sections 117–121 of the Companies Act, which deal with security granted to a trustee for debenture-holders and the priority of the claims of such debenture-holders, are unnecessary. If the trust is founded in the manner described below,<sup>178</sup> it will fall under the provisions of the Trust Property Control Act.<sup>179</sup> Further regulation in the Companies Act is then unnecessary and only leads to confusion as to the legal form of a trust for debenture-holders.<sup>180</sup> The registration of security in favour of a trustee for debenture-holders and of registration of debentures should be regulated in the Deeds Registries Act.<sup>181</sup> At present the provisions in sections 117–121 of the Companies Act are not consistently enabled in the Deeds

<sup>175</sup> 61 of 1973.

<sup>176</sup> See James Hart, Saul Greenberg & Paul Kerlogue “Moody’s Approach to the Legal Risk Analysis in South African Securitisation Structures” (2003) *Moody’s Investors Service* at 5.

<sup>177</sup> The Companies Bill 61 of 2008 makes provision for the appointment of a trustee for the holders of debt instruments, but makes no mention of security held by such a trustee on behalf of the holders of debt instruments. See cl 43(5). The uncertainty about whether such a trustee may hold security in favour of creditors other than the holders of debt instruments is not addressed by the Bill. The comments made here therefore apply unchanged to the Bill.

<sup>178</sup> See par 2.8.2.2.2.

<sup>179</sup> 57 of 1988.

<sup>180</sup> See par 2.8.2.2.2.

<sup>181</sup> 47 of 1937.

Registries Act.<sup>182</sup> It is therefore to be welcomed that the Companies Bill<sup>183</sup> does away with all these provisions, apart from stating that a trustee for the holders of debt instruments may be appointed.<sup>184</sup>

When one views the trust for debenture-holders not as a creation of the Companies Act, but as a trust in terms of the Trust Property Control Act, transaction creditors other than debenture-holders can be secured through the same trust. The order in which the creditors as the beneficiaries under the trust will share in the proceeds of realised security can be determined in the trust deed.

The uncertainty about the use of trusts for debenture-holders is further due to the lack of research pertaining to their legal form, as well as a lack of case law in this area. I shall therefore start my discussion with the security SPV currently preferred in practice in South African securitisations, and shall then continue with a thorough consideration of the legal form of a trust that holds security on behalf of specified beneficiaries, such as debenture-holders.

#### 2.8.2.1 Security SPV

In paragraph 2.3.3 I discussed how the insolvency-remoteness of the issuer SPV is enhanced by the inclusion of non-petition clauses in the transaction documentation. Transaction creditors, such as the rating agency, servicer and credit enhancers undertake not to institute an application for the winding-up of the issuer SPV before two years after the claims of the holders of the securities of the issuer SPV have been paid in full. However, in return for this undertaking, the transaction creditors require that their claims be secured by the assets of the issuer SPV.

In order to secure the claims of both the transaction creditors and the holders of the securities issued by the issuer SPV, the rating agencies recommend the use of a second SPV, to which I shall refer as the 'security SPV'.<sup>185</sup> It is important to note that

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<sup>182</sup> See par 2.8.2.2.2.1.

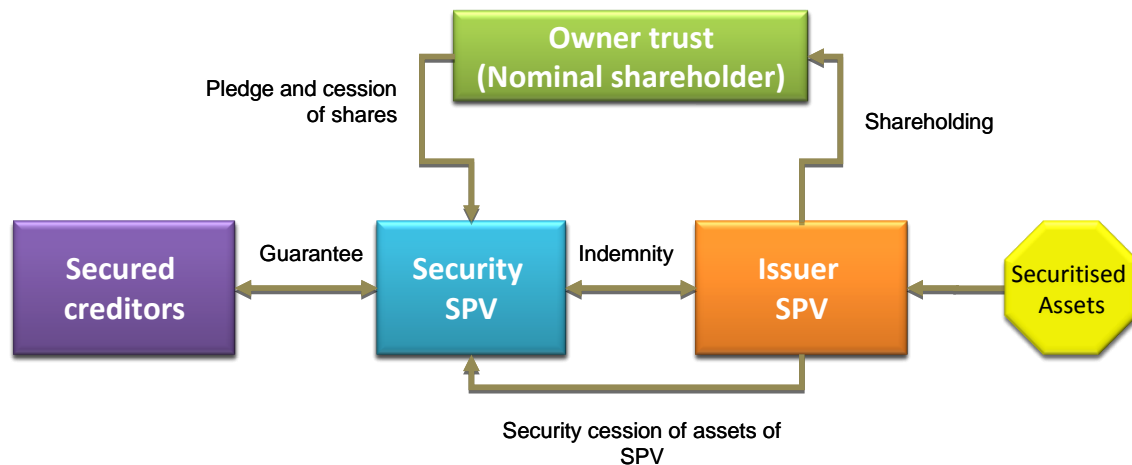
<sup>183</sup> 61 of 2008.

<sup>184</sup> The Bill also prescribes that the trustee must be a person unconnected with the company (cl 43(5)), that the trustee must be approved by 75 per cent in value of the holders of the debt instruments present at a meeting called for that purpose (cl 43(6)), and provisions prohibiting the blanket indemnification of the trustee for breaches of trust and negligence (cl 43(7) and (8)).

<sup>185</sup> See Figure 2. My thanks to Wildu du Plessis from Werksmans Attorneys who provided me with information on the typical structure.

the security SPVs used during securitisation in South Africa have thus far only been companies.

The security scheme works as follows:<sup>186</sup> the security SPV binds itself towards all the transaction creditors and the holders of the securities as guarantor of the obligations of the issuer SPV.<sup>187</sup> When the issuer SPV defaults in respect of its obligations, the security SPV will be liable to fulfil those obligations. The issuer SPV indemnifies the security SPV in the event that the guarantee becomes effective. The obligation in terms of the indemnity is secured by a pledge of the shares in the issuer SPV in favour of the security SPV by the shareholders (in the example an owner trust created specifically to hold the shares in the issuer SPV). It is further secured by way of a fiduciary security cession of the assets of the issuer SPV. The extent of the liability of the security SPV towards the creditors in terms of the guarantee is limited to the amount recovered from the issuer SPV in terms of the indemnity.



**Figure 2: Security scheme using security SPV**

The guarantee sets out the priority according to which the transaction creditors and the holders of the securities will share in the proceeds of the realised security. Usually the Revenue Service is paid first, followed by specified transaction creditors who provided services during the structuring of the scheme, such as the rating agency and law firms. Payment in terms of these claims is usually capped. Next, the holders of the securities in the issuer SPV are paid in the order determined by the terms of issue of the securities. For instance, if class B securities are subordinated to class A securities, the holders of the class B securities will receive payment in terms of the guarantee

<sup>186</sup> See Figure 2.

<sup>187</sup> See par 5.4.1 for the definition of a ‘guarantee’.

after the holders of the class A securities. The provider of any liquidity facility to the scheme ranks *pari passu* with the holders of the securities, because payments made in terms of the liquidity facility go directly towards timeous payment of the obligations of the issuer towards the holders of the securities. Last in line are the credit enhancement providers. Their role during the securitisation scheme is to minimise the risk that the holders of the securities will not receive full payment. It makes sense that they should therefore only receive any benefits from the security after the claims of the holders of the securities have been fully settled.

The investors and the other transaction creditors will all be *unsecured* creditors of the security SPV when the guarantee is called up. Furthermore, it is unclear what the rights of the third party credit enhancers will be with regard to set-off under this scheme. The assets transferred to the security SPV will include the claims of the issuer SPV in terms of its credit enhancement agreements. In other words, it is very possible that a provider of credit enhancement could be both a creditor and a debtor of the security SPV. Presumably the providers of credit enhancement will abandon any rights to set-off.

The amount available to the creditors will immediately be reduced according to the size of the indemnity that the issuer SPV can provide. The security SPV will be a creditor of the issuer SPV and will therefore be able to institute action in terms of section 424 of the Companies Act<sup>188</sup> if it turns out that the issuer SPV was managed fraudulently or recklessly.<sup>189</sup> However, the security SPV will not have any duty towards the transaction creditors and the investors outside of its contractual obligations in terms of the guarantee. The extent of this guarantee is adjusted according to what the issuer SPV can provide. There is no incentive for the security SPV to increase the extent of its guarantee, especially since the security SPV will have no other assets to fall back on if the litigation is unsuccessful. Surely it will try to limit such liability. It has no incentive to enlarge the pool of funds available to the transaction creditors and the investors outside of that made available by the issuer

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<sup>188</sup> 61 of 1973.

<sup>189</sup> Section 424(1) reads as follows: “When it appears ... that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.”



SPV, by looking at the management of the issuer SPV or at the non-fulfilment of the servicer's obligations.

Since the security SPV is usually a company, the directors of the security SPV do not have a fiduciary duty towards its creditors.<sup>190</sup> The directors of the security SPV are usually independent of both the issuer SPV and the parties to be secured by the security SPV. This function is often undertaken by professional trust companies.<sup>191</sup> The security SPV performs the monitoring functions typically undertaken by a trustee for debenture-holders.

However, the security SPV will never be a representative of the debenture-holders in the sense that a trustee for debenture-holders is. The security SPV has no discretionary powers such as those usually available to a trustee for debenture-holders.<sup>192</sup> It will not have the power to make minor adjustments to the security agreements on behalf of the debenture-holders. Furthermore, regardless of its own monitoring of the issuer SPV, the security SPV does not primarily serve the interests of the debenture-holders or of the other transaction creditors, but is a separate legal person, and potentially itself a debtor of the debenture-holders and of the transaction creditors.

This security scheme has never been put to the test in circumstances when the originator or the issuer SPV is under insolvent liquidation. If the originator is under insolvent liquidation, its liquidator may argue that the sale of the assets to the issuer SPV was not a true sale, but merely a secured loan. If this argument is accepted by a court, the debenture-holders will be unsecured creditors of the SPV and the SPV's only asset will be a loan made to an insolvent originator. The debenture-holders stand to lose most under such a situation.

I submit that if the true sale of the assets of the originator to the issuer SPV is ever under dispute in a South African court, the security SPV will not have standing to act on behalf of the debenture-holders to prove that those assets, in fact, belong to the issuer SPV. The security SPV will have to call a meeting of the debenture-holders to try and get a mandate to act on their behalf in such proceedings. Even then, every individual debenture-holder would be able to refuse to give a mandate and opt to

<sup>190</sup> See the discussion at par 2.3.2.

<sup>191</sup> See, for instance, [www.sentineltrust.co.za](http://www.sentineltrust.co.za) and [www.maitlandgroup.com](http://www.maitlandgroup.com) (accessed 23 November 2007).

<sup>192</sup> See par 2.8.3.

oppose the application of the liquidator independently. Calling a meeting of debenture-holders will be time-consuming, whereas one of the main benefits of the trustee for debenture-holders is that the trustee can act swiftly on behalf of the debenture-holders to protect their interests.

If the issuer SPV is insolvent, the guarantee of the security SPV must be called up. Thereafter the security SPV becomes the debtor of the debenture-holders and the other transaction creditors. I have two concerns regarding the absence of a trustee for debenture-holders under these circumstances. First, the security SPV serves not only as guarantor but also as monitor of the issuer SPV. There is no independent party that can insist on the activation of the guarantee if need be. Second, after the security SPV has become liable under the guarantee there will be no person to guard over the interests of the debenture-holders collectively. At this stage there will be no one to monitor the security SPV's obligations under the guarantee for the debenture-holders.

I am therefore of the opinion that even when the security SPV is used, it will be beneficial to have a separate trustee for debenture-holders. The trust for debenture-holders must be founded under the true trust construction discussed below, so that the trustee will be the holder of the claims against both the security SPV and the issuer SPV, and will be able to institute proceedings if necessary. The claims of the debenture-holders will still not be directly secured by the assets of the SPV, but only by the guarantee provided by the security SPV. However, at least the trustee will be an independent party to serve the interests of the debenture-holders and to call up the guarantee if necessary.

#### 2.8.2.2 Legal form of trust for debenture-holders

I now consider what legal form a trust for debenture-holders could take in South African law. The discussion is relevant to all issues of corporate debt and not only to securitisation transactions. As a matter of convenience I shall refer throughout to a 'trust for debenture-holders', although, in my opinion, the beneficiaries under at least three of these constructions need not only be debenture-holders.

### 2.8.2.2.1 Agency construction

The terms ‘trust’ and ‘trustee’ are generally used in a wide sense or in a narrow sense.<sup>193</sup> If applied in a wide sense, the term ‘trust’ may refer to any situation where someone is bound to hold or administer property on behalf of another or for some impersonal object and not for his own benefit.<sup>194</sup> Various persons may be referred to in this sense, for instance, guardians of children, the curators of mental patients, executors of deceased estates and agents who hold money or property for their principals.

A ‘trust’ in the strict or narrow sense exists when a founder has transferred ownership of trust property to a trustee, who is to administer or dispose of the property and/or the proceeds of the property for the benefit of some person other than the trustee, as beneficiary, or for some impersonal object.<sup>195</sup> The separation of control and benefit of the trust property is also a feature of the trust in the wide sense, but the difference is that a trustee in the narrow sense holds an office and falls under the control of the Master of the High Court.<sup>196</sup> This definition of ‘trust’ is the one that corresponds with the definition provided in section 1 of the Trust Property Control Act.<sup>197</sup>

<sup>193</sup> See Edwin Cameron *et al Honoré’s South African Law of Trusts* 5 ed (2002) at 3–4; F du Toit *South African Trust Law: Principles & Practice* (2002) at 2–3; *Conze v Masterbond Participation Bond Trust Managers (Pty) Ltd* 1996 (3) SA 786 (CPD) at 794D–F.

<sup>194</sup> Cameron *et al Honoré’s* at 3; Du Toit *Trust Law* at 2; *Zinn NO v Westminster Bank NO* 1936 AD 89 at 96: “[Trustee] means one who is entrusted with the affairs of another.” See further Wiechers & Roos *Trusts* at 68.

<sup>195</sup> Cameron *et al Honoré’s* at 4, Du Toit *Trust Law* at 2; *Crookes NO v Watson* 1956 (1) SA 277 (A) at 305A; *Braun v Blann NNO* 1984 (2) SA 850 (A) at 859H. Trustees in insolvency fall under the definition of ‘trustee’ in the narrow sense. See Cameron *et al Honoré’s* at 5. Their appointment and duties are regulated by the Insolvency Act 24 of 1936.

<sup>196</sup> Du Toit *Trust Law* at 3; s 6 of the Trust Property Control Act 57 of 1988.

<sup>197</sup> 57 of 1988. This definition reads: “‘Trust’ means the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed – (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument.”

To date only one reported decision has considered the nature of a trust for debenture-holders. In *Conze v Masterbond Participation Bond Trust Managers (Pty) Ltd*<sup>198</sup> the Court held *on the facts* that the trust for debenture-holders was only a trust in the wide sense, namely an agency, and that consequently the provisions of the Trust Property Control Act<sup>199</sup> did not apply.<sup>200</sup>

The facts were briefly as follows:<sup>201</sup> The Masterbond group invited members of the public to invest money with it. It would then act as an agent for those investors and place the money with third parties for project finance purposes. The third parties issued debentures to the investors and secured them by means of a mortgage bond in favour of Masterbond as the trustee for the debenture-holders.

One project financed in this manner was with a company called Fancourt (Pty) Ltd, which was the scheme considered by the Court in its judgment. After Masterbond had been placed under curatorship in terms of section 6 of the Financial Institutions (Investment of Funds) Act,<sup>202</sup> some of the Fancourt debenture-holders tried to oust Masterbond as the trustee for debenture-holders. However, they could not obtain the two-thirds majority required by the trust deed for the removal of Masterbond as trustee. Subsequently the applicant, one of the debenture-holders, sought an order declaring that Masterbond was bound by the provisions of the Trust Property Control Act.<sup>203</sup> If so declared, Masterbond would not have complied with the requirements of the Act in terms of authorisation by the Master and in providing security for the due and faithful performance of its duties. This could mean that all the actions of Masterbond, including those of its curators, could be invalid because they did not comply with the Act.

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<sup>198</sup> 1996 (3) SA 786 (C), hereinafter referred to as the *Masterbond* decision. The early decision *Jagger & Co v Registrar of Deeds* 1924 CPD 279 at 281 also held that the trustee for debenture-holders was really an agent of the debenture-holders. However, the reported judgment does not provide enough detail of the arrangement between the parties for me to comment on the correctness of the Court's finding.

<sup>199</sup> 57 of 1988.

<sup>200</sup> At 794H-I.

<sup>201</sup> *Conze v Masterbond Participation Bond Trust Managers (Pty) Ltd* 1996 (3) SA 786 (CPD) at 788I-792C.

<sup>202</sup> 39 of 1984. This Act was subsequently repealed and replaced by the Financial Institutions (Protection of Funds) Act 28 of 2001.

<sup>203</sup> 57 of 1988.

The central issue for consideration was therefore whether Masterbond as trustee was subject to the Trust Property Control Act. The Court found that the description of Masterbond as ‘trustee’ in the trust deed was not helpful in determining the nature of the relationship.<sup>204</sup> This description was contradicted by the application form signed by investors in Masterbond in which they confirmed that Masterbond would “only act as an agent” on behalf of the investors for the purpose of investing funds in debentures.<sup>205</sup>

The Court held that the vesting of the security in Masterbond did not constitute ownership of property as required by the Trust Property Control Act, but that it constituted *jura in re aliena*.<sup>206</sup> It held that sections 117 and 118 of the Companies Act,<sup>207</sup> which provide for the creation of security in favour of a trustee for debenture-holders, constituted an exception to section 54 of the Deeds Registries Act.<sup>208</sup> Section 54 prohibits the registration of a mortgage in favour of an agent.<sup>209</sup> The debenture-holders remained entitled to claim payment of the amounts owed to them.<sup>210</sup> The entitlement to enforce the claims of the debenture-holders was never transferred to Masterbond. The debenture certificates provided that Fancourt would pay capital debt and interest to the debenture-holders.<sup>211</sup> The fact that Masterbond received and distributed these payments to the debenture-holders did not have any bearing.

Consequently, ownership had not been transferred to Masterbond by virtue of the trust instrument, which meant that the Trust Property Control Act did not apply to the purported trust for debenture-holders.<sup>212</sup> The true relationship between the ‘trustee’ and the debenture-holders in that case was one of agency.<sup>213</sup>

<sup>204</sup> At 793C–F. See also Cameron *et al Honoré’s* at 119.

<sup>205</sup> At 793I.

<sup>206</sup> At 794H. *Jura in re aliena* refers to real rights to someone else’s things. See Van der Merwe *Sakereg* at 69; PJ Badenhorst, Juanita M Pienaar & Hanri Mostert *Silberberg and Schoeman’s The Law of Property* 5 ed (2006) at 56.

<sup>207</sup> 61 of 1973.

<sup>208</sup> 46 of 1937. The section reads: “No mortgage bond or notarial bond shall be passed in favour of any person as the agent of a principal.”

<sup>209</sup> At 795B.

<sup>210</sup> At 794I.

<sup>211</sup> At 795E–F.

<sup>212</sup> At 795F.

<sup>213</sup> At 795B–C.

Throughout its judgment, the Court was careful to restrict the application of its judgment to the particular facts of the case.<sup>214</sup> It further held that determining whether the Trust Property Control Act applied would be academic, because in the Court's opinion the curatorship order was cast in the widest possible terms and could not be defeated in the manner envisaged by the applicant.<sup>215</sup>

The decision leaves open the possibility of distinguishing future cases on their facts in order to hold that a trust for debenture-holders may also be a trust in the strict sense. Accordingly, determining the nature of the trust for debenture-holders will be factual, and one must make a clear distinction between trusteeship and agency. The main points of distinction between trusteeship and agency are as follows:<sup>216</sup>

- Trusteeship is an office and a trust is an institution of public concern. This is reflected in the fact that the Master and the courts have the authority to take the necessary steps to ensure that the trust is properly administered.<sup>217</sup> It further means that the trustee has a certain independence from the founder and the beneficiaries.<sup>218</sup> If the founder may revoke the trust unilaterally or if the trustee is bound to follow the instructions of the founder or of the beneficiaries, this may be an indication of agency rather than trusteeship.<sup>219</sup> The principal of an agent is entitled to revoke the mandate, thereby terminating the agency agreement.<sup>220</sup> An agent is in the service of his principal: he does what the principal finds

<sup>214</sup> For instance, “the trust deed in the present case” and “the trust deed in question” (at 794H); “the TPC Act does not apply to the debenture trusts involved in this case.” (at 795F); “A trustee for debenture-holders ... is not *necessarily* a trustee as defined in the TPC Act (my emphasis).” (at 794D). See also Lynette Olivier “The Law of Trusts: Some Reflections on Recent Decisions” (1997) *TSAR* 765 at 770 where she comes to the same conclusion. In *Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 (1) SA 404 (NPD) at 409A and 409F the Court held on the facts that the trust was valid and therefore the mortgage was registrable. By implication the Court would have rejected the registration of the bond in that case if it found that the deed did not create a valid trust.

<sup>215</sup> At 798. More than 20 000 investors stood to lose money, totalling an amount of more than R500 million.

<sup>216</sup> *Cameron et al Honoré's* at 73.

<sup>217</sup> *Cameron et al Honoré's* at 11–12. If the trustee is a financial institution or controlled by a financial institution, it must further comply with the Financial Institutions (Protection of Funds) Act 28 of 2001, which falls under the supervision of the Registrar of Banks.

<sup>218</sup> See *Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 (1) SA 404 (NPD) at 410D.

<sup>219</sup> *Cameron et al Honoré's* at 91.

<sup>220</sup> AJ Kerr *The Law of Agency* 4 ed (2006) at 243.

impracticable, inconvenient or difficult to do himself.<sup>221</sup> Since agency is a form of service, the agent must do what he is instructed to do.<sup>222</sup>

- There is always transfer of ownership in a trust.<sup>223</sup> Ownership of the trust property is either transferred to the trustee or to the beneficiaries.<sup>224</sup> If there is no cession of the debenture-holders' claims to the trustee, this will be an indication of agency,<sup>225</sup> especially if the security rights were also granted in the debenture-holders' favour and the entitlement to exercise those rights still vests in them.
- Agency is usually revocable at the will of the principal,<sup>226</sup> whereas the trustee's office is independent.

With these characteristics in mind, a typical trust for debenture-holders under the agency construction will be arranged as follows:<sup>227</sup> each debenture-holder is a creditor of the company,<sup>228</sup> and may personally sue for payment of the principal debt and interest. The rights to the security are vested in the debenture-holders,<sup>229</sup> but the trustee, who is really only an agent, is mandated to monitor compliance by the issuer with the transaction agreements and, if necessary, to enforce the security on their behalf.<sup>230</sup>

<sup>221</sup> Kerr *Agency* at 3.

<sup>222</sup> Kerr *Agency* at 136.

<sup>223</sup> Olivier 1997 *TSAR* at 771 mentions this as a possible manner in which to distinguish between a *bewind* trust and agency. I consider this to be a useful distinction.

<sup>224</sup> See the definition of 'trust' in s 1 of the Trust Property Control Act 57 of 1988 in n 197.

<sup>225</sup> On the aspect of control in trusts see Lynette Olivier "Trusts: Traps and Pitfalls" (2001) 118 *SALJ* 224; Basil Wunsh "Trading and Business Trusts" (1986) 103 *SALJ* 561 at 575–576.

<sup>226</sup> Kerr *Agency* at 194. An agreement between the principal and the agent that the mandate shall be irrevocable does not deprive the principal of his power to revoke the mandate, but if the principal does revoke the mandate he may be liable to pay damages. The mandate can definitely be revoked if the agent is in breach. See Kerr *Agency* at 196 *et seq.*

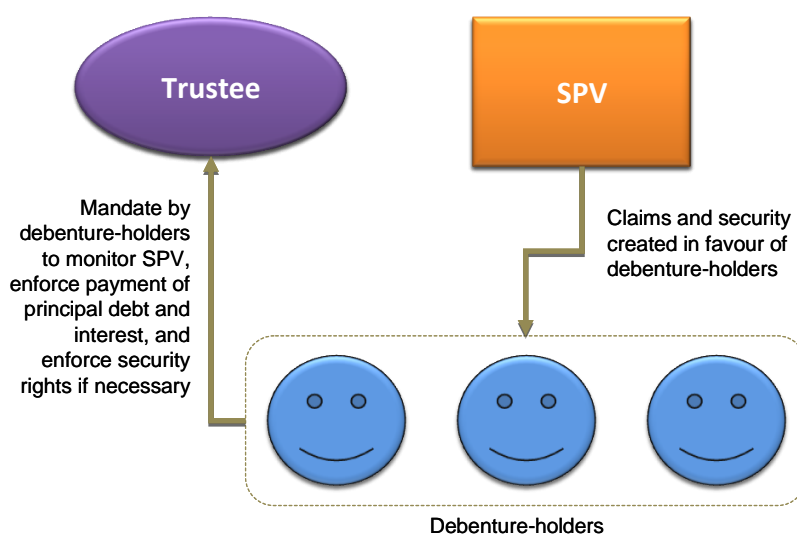
<sup>227</sup> See Figure 3.

<sup>228</sup> The 'company' in the context of securitisation is the issuer SPV.

<sup>229</sup> This is necessary for compliance with the accessory nature of real security rights. Both the security and the underlying claim must vest in the same person. See Thiele *Collective Security Arrangements* at 230.

<sup>230</sup> This must be distinguished from the 'fiscal agent' found in some financing transactions in English law. The fiscal agent is an agent of the issuer. He undertakes a range of administrative functions on behalf of the issuer, especially as principal paying agent. A principal paying agent distributes the money due to the debenture-holders. However, a fiscal agent does not monitor the business of the issuer on behalf of the debenture-holders. See Rawlings 2007 *JBL* at 46.

The trust deed, which is really a mandate, authorises the trustee to call meetings of the lenders if, in his opinion, it becomes necessary to enforce the security or if the security arrangements must be amended. The trustee never becomes entitled to the principal debt, but acts as an agent for the debenture-holders with regard to the enforcement of the security. By implication, each new debenture-holder must consent to the mandate given to the trustee to control the security.<sup>231</sup> Such consent could be made a condition of the transfer of the debentures, but this will complicate the arrangement.



**Figure 3: Agency construction of a debenture trust**

However, as South African law currently stands, it is not possible to register security in the name of the trustee for debenture-holders *as their agent*. The authors of *Blackman*<sup>232</sup> argue that if the debenture trust arrangement is truly one of agency, it would not be possible to register security in the name of the trustee as agent for debenture-holders. The authors do not agree with the view of the Court in *Masterbond* that section 117(3) of the Companies Act<sup>233</sup> creates an exception to the prohibition in section 54 of the Deeds Registries Act.<sup>234</sup> I agree with these authors that section

<sup>231</sup> This aspect is still uncertain in Dutch law, where the agency construction is also used. See Thiele *Collective Security Arrangements* at 81 and 105. For the position in German law, see Thiele *Collective Security Arrangements* at 221.

<sup>232</sup> MS Blackman, RD Jooste & GK Everingham *Commentary on the Companies Act* (2008) at par 5-338.

<sup>233</sup> 61 of 1973.

<sup>234</sup> 47 of 1937. See above.



117(3) makes no mention of such an exception.<sup>235</sup> Nor can I find any other provision in the Companies Act that would lead to such a conclusion. The prohibition in section 54 of the Deeds Registries Act contains no exceptions. The Court in *Masterbond* was therefore, in my view, incorrect in finding that section 117(3) creates the possibility of registering security in the name of a trustee for debenture-holders as their agent.

Consequently, the security will have to be registered in the names of the individual debenture-holders.<sup>236</sup> Priority is determined by the date of registration in the case of mortgages and special notarial bonds. It will therefore be impossible to give the debenture-holders equal priority. Registration of security rights for potentially thousands of debenture-holders is impractical from a financial and administrative point of view. Registration in the names of the individual debenture-holders further implies that each transfer of the debenture would mean that the cession of the security must be registered. This may severely restrict the transferability of the debentures. The agency construction will therefore only work if there are relatively few debenture-holders who do not foresee the transfer of the debentures. This will obviously not be advantageous for a securitisation scheme.

The agency construction of a trust for debenture-holders is therefore not functionally the best option. However, the construction is used in other jurisdictions and may be acceptable where there are only a few debenture-holders.<sup>237</sup> In the context of securitisation, as well as for large issues of corporate debt, I prefer the trust construction.

#### 2.8.2.2.2 *Trust construction*

<sup>235</sup> Section 117(3) reads: “The binding as aforesaid of immovable property may be effected by a mortgage bond, collateral mortgage bond or surety bond executed in favour of one or more debenture-holders or of a trustee for debenture-holders.”

<sup>236</sup> If the arrangement is, on the face of it, an agency, it may not be registered, because s 54 is peremptory. However, there is at least one decision that held that a bond registered in favour of an agent will not render the bond a nullity (*Bay Loan Investment (Pty) Ltd v Bay View (Pty) Ltd* 1972 (2) SA 313 (CPD) at 316B. The Court held that the true intention between the parties was to create an agency). Under such circumstances, only the registered mortgagee will be recognised in law as the holder of rights and not the unmentioned parties (at 315C–E). However, the accessory nature of the security will then limit the amount so secured to the value of the claims held by the agent, if any. See Strydom *Die Aksessoriteitsbeginsel* at 86–90. The Court did not consider this aspect in its judgment.

<sup>237</sup> For a discussion of the agency construction in Dutch law, English law (although rarely used) and German law, see Thiele *Collective Security Arrangements* at 60–83, 145–159, and 213–225. The author rejects the agency construction as inefficient and impractical (at 244).

Under the trust construction of the debenture trust, compliance with the Trust Property Control Act is necessary.<sup>238</sup> This means that the trust document must be lodged with the Master of the High Court<sup>239</sup> and the trustee must be authorised in writing to act as such by the Master.<sup>240</sup> The applicability of the Act further means that the Master can fill a vacancy in the position of trustee if the trust instrument does not provide for it or if the position cannot be filled in accordance with the trust instrument.<sup>241</sup> This will happen in consultation with the interested parties who will, for purposes of this discussion, be the debenture-holders and the management of the SPV. The Master may also appoint a co-trustee when he deems it desirable, notwithstanding the provisions of the trust instrument.<sup>242</sup>

Together with these procedural aspects, the Act brings a measure of protection to the beneficiaries, which makes the trust construction preferable to the agency construction. The most important consequence of the Act is that it separates the trust property from the personal estate of the trustee.<sup>243</sup> It also requires proper bookkeeping and requires that trust property be clearly registered as such.<sup>244</sup> It makes the trustee accountable to the Master when called upon to do so.<sup>245</sup>

The Act grants the court the power to vary provisions of the trust instrument which the founder of the trust did not in the court's opinion contemplate or foresee.<sup>246</sup> The court will vary the trust instrument if it hampers the achievement of the object of the trust or prejudices the beneficiaries or is in conflict with the public interest. The trustee or any person who in the court's opinion has a sufficient interest in the trust property, may apply for such a variation. In a securitisation scheme the trustee, the debenture-holders, and even the SPV under certain circumstances, may qualify to bring such an application.

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<sup>238</sup> References to 'the Act' in this par are to the Trust Property Control Act 57 of 1988.

<sup>239</sup> Section 4.

<sup>240</sup> Section 6.

<sup>241</sup> Section 7(1).

<sup>242</sup> Section 7(2).

<sup>243</sup> Section 12. This consequence is also specifically provided for in s 4(5) of the Financial Institutions (Protection of Funds) Act 28 of 2001.

<sup>244</sup> Sections 17, 18 and 11(1)(a) and (b).

<sup>245</sup> Sections 15 and 16.

<sup>246</sup> Section 13.

The court may order the removal of a trustee on application by the Master or by any person with an interest in the trust property, if the court is satisfied that the removal of the trustee will be in the interests of the trusts and its beneficiaries.<sup>247</sup> Under certain prescribed circumstances, the Master may also remove a trustee without intervention of the court.<sup>248</sup>

#### 2.8.2.2.1 *Aspects of Companies Act 61 of 1973*

Section 121(1) of the Companies Act<sup>249</sup> provides that despite the appointment of a trustee, and unless specifically limited in the trust deed, each debenture-holder is entitled to enforce his rights in terms of the debenture as if he were himself the holder of the security.<sup>250</sup> *Blackman*<sup>251</sup> argues that section 121(1) means that each debenture-holder remains entitled to enforce his right to claim payment of the principal debt and interest, even though the security rights are vested in the trustee. In other words, the authors argue that the debenture-holders could enforce the right to claim the principal debt and interest owed to them, but not to enforce the security rights granted in favour of the debenture-holders.

I do not agree with this interpretation.<sup>252</sup> The section reads that the debenture-holder remains entitled to enforce “his rights under such debenture ... in the same manner as if he were himself the pledgee or holder of such bond.” Owing to the accessory nature of real security rights,<sup>253</sup> these rights cease to exist when the underlying debt is terminated. It is therefore not possible that the underlying debt

<sup>247</sup> Section 20(1).

<sup>248</sup> Section 20(2).

<sup>249</sup> 61 of 1973.

<sup>250</sup> “Every holder of a debenture secured by a pledge or a bond executed in favour of a trustee for debenture-holders generally shall, *unless it is otherwise provided by the deed of pledge, bond or trust deed and copy of the debenture annexed thereto*, be entitled to enforce his rights under such debenture as soon as it has been issued to him in the same manner as if he were himself the pledgee or holder of such bond (my emphasis).”

<sup>251</sup> *Blackman et al Commentary* at par 5-340. Reference is made to *Brown v Natal Cambrian Collieries Ltd* 1916 NPD 137. However, the debenture-holders in that case did not seek to enforce their security, but only compliance with the terms of the debentures. The right to claim the principal debt and interest will always vest in the debenture-holders, unless it is specifically ceded to the trustee. It is further evident from that case that the trustee and the other debenture-holders were not in favour of compliance with the terms of the debentures, but rather opted for a five year extension on the terms of the debenture.

<sup>252</sup> See *Meskin et al Henochsberg* at 229 who seem to agree with my interpretation.

<sup>253</sup> See in general Natania Strydom *Die Aksessoriteitsbeginsel in die Suid-Afrikaanse Reg* (2000 dissertation, RAU (now the University of Johannesburg)).

vests with the debenture-holders, but the security for that debt with the trustee. I understand this section to mean that unless the security agreement or trust deed provides otherwise, each debenture-holder will be able to enforce the security rights accessory to the debenture individually, even if the security was granted in the name of a trustee. However, if the security agreement or trust deed vests the entitlement to enforce the security in the trustee, the individual debenture-holders will not be entitled to enforce the security individually.

The entitlement to enforce the security, along with the entitlement to enforce payment of the principal debt and interest, is almost always curtailed in the security agreement and in the trust deed. In my opinion, this reflects the usefulness of the trust for debenture-holders, namely that debenture-holders elect to let the trustee enforce payment of the principal debt and interest and if necessary the security on their behalf. The use of the expression “as if” in section 121(1) of the Companies Act is unfortunate, because it creates the impression that the debenture-holders could not be the holders of the security rights. It is, in my view, possible for a debenture-holder to be the security right holder, but that the entitlement to enforce the security right is transferred to the trustee.<sup>254</sup>

In view of the purpose of the trust for debenture-holders, and with the protections afforded by the Trust Property Control Act<sup>255</sup> in mind, one must ask whether the aim of section 121(1) is still valid. I do not think that section 121(1) serves any useful purpose, nor could I find contrary evidence from any South African author. It is not in accordance with modern finance practice to allow individual debenture-holders to institute proceedings against the company.<sup>256</sup>

In terms of section 120 of the Companies Act,<sup>257</sup> debenture-holders who hold debentures issued in serie, which are secured by security in favour of a trustee for debenture-holders, might rank equal as regards the security, irrespective of when they acquired the debentures.<sup>258</sup> The security agreement must make specific provision for this to take effect.

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<sup>254</sup> See par 2.8.2.2.2.3.

<sup>255</sup> 57 of 1988.

<sup>256</sup> Rawlings 2007 *JBL* at 47.

<sup>257</sup> 61 of 1973.

<sup>258</sup> See also Blackman *et al Commentary* at par 5-339.

This provision is an exception to the accessory nature of security rights. Usually the creation of real security is dependent on the existence of a principal debt. Alternatively, there must be compliance with the provisions of section 51 of the Deeds Registries Act.<sup>259</sup> Section 51 provides for the registration of bonds to secure future debts. Such a bond must expressly stipulate that it is intended to secure future debts generally or a particular future debt described,<sup>260</sup> and must stipulate a maximum amount beyond which future debts shall not be secured by the bond.<sup>261</sup>

Section 51 was not amended after section 120 of the Companies Act had come into existence and one should therefore assume that the registration of a security in terms of section 120 of the Companies Act will still have to comply with section 51 in order to secure the future debts incurred towards the debenture-holders. Section 51 is peremptory: compliance is necessary for the validity of the security.<sup>262</sup>

My conclusion is that section 51 remains applicable and is strengthened by section 124 of the Companies Act, which provides that debentures redeemed by the company may be reissued at a later stage, unless the articles of association or by the terms of issue of the debentures prohibit this.<sup>263</sup> In other words, it is possible that no debentures are issued at a specific time, but that they may be reissued in future. Owing to their accessory nature, real security rights cease to exist automatically when the underlying claims are satisfied. In my opinion, the security for such debentures would have to comply with section 51 to remain valid under such circumstances, otherwise the security rights will cease to exist automatically in the event of the redemption of the debentures.<sup>264</sup>

In terms of section 87 of the Insolvency Act,<sup>265</sup> priority under a mortgage bond to secure future debts depends on the date of registration of the bond and not on the date

<sup>259</sup> 47 of 1937.

<sup>260</sup> Section 51(1)(a) of the Deeds Registries Act 46 of 1937.

<sup>261</sup> Section 51(1)(b) of the Deeds Registries Act 46 of 1937.

<sup>262</sup> Section 51(1) reads: “No mortgage bond or notarial bond attested or registered after the commencement of this Act shall be of force or effect for the purpose of giving preference or priority in respect of any debt incurred after the registration of such bond, unless ...”

<sup>263</sup> It is essential that the reissue be made under the same terms as the original debentures, otherwise they will not be considered a reissue but a fresh issue and the security will not cover the fresh issue. See Blackman *et al Commentary* at par 5-346 to 5-347.

<sup>264</sup> On s 51 and its deviation from the accessory nature of security rights in general, see Strydom *Die Aksessoriteitsbeginsel* at 57–60.

<sup>265</sup> 24 of 1936.

that the debts come into existence. This provision is, of course, dependent on compliance with section 51 of the Deeds Registries Act;<sup>266</sup> otherwise no valid mortgage or notarial bond would have been created.<sup>267</sup>

Section 120 of the Companies Act is only relevant under the *bewind* trust construction of the trust for debenture-holders.<sup>268</sup> If the trustee was really the holder of the security rights and not the individual debenture-holders, and there was compliance with section 51 of the Deeds Registries Act, section 120 will be superfluous. This is so because the security rights would remain with the trustee and the debenture-holders would simply be beneficiaries of the trust. The holders of each class of debentures will rank concurrently as beneficiaries under the trust.

#### 2.8.2.2.2.2 *Transfer of ownership*

The definition of ‘trust’ in the Act requires that there has to be a transfer of ownership of the trust property to either the trustee or to the beneficiaries.<sup>269</sup> ‘Trust property’ in terms of the Act means “movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by the trustee”.<sup>270</sup>

Although not defined by the Act, it seems that a transfer of ownership means that the trustee, or the beneficiary, must become the holder of the transferred right.<sup>271</sup> Real security rights will only vest in a person if that person is also the holder of the claims which the real security right aims to secure. This is because real security rights are accessory in nature, which means that they are dependent on the existence of a claim for their creation and continued existence.<sup>272</sup> The trust for debenture-holders will be a trust in the strict sense, and the provisions of the Act will apply, if both the claims and

<sup>266</sup> 47 of 1937.

<sup>267</sup> See also s 342 (1) of the Companies Act 61 of 1973: “In every winding-up of a company the assets shall be applied in payment of ... the claims of creditors as nearly as possible as they would be applied ... under the law relating to insolvency.”

<sup>268</sup> See par 2.8.2.2.2.3.

<sup>269</sup> See the definition in n 197.

<sup>270</sup> Section 1.

<sup>271</sup> See also Basil Wunsh *Annual Survey of South African Law* (1996) at 475–476; Cameron *et al Honoré’s* at 74.

<sup>272</sup> See *Kilburn v Estate Kilburn* 1931 AD 501 at 506: “It is therefore clear that by our law there must be a legal or natural obligation to which the hypothecation is accessory. If there is no obligation whatever there can be no hypothecation giving rise to a substantive claim.” See also *Thienhaus v Metje & Ziegler Ltd* 1965 (3) SA 25 (A) at 32 F–G; Strydom *Die Aksessoriteitsbeginsel* at 1–3.

the security vest in the trustee.<sup>273</sup> Otherwise, the claims and the security must both vest in the debenture-holders. However, the trust for debenture-holders may still be a *bewind* trust under these circumstances if the trust deed is drafted in such a manner that the debenture-holders are not entitled to *control* the enforcement of their security rights and their rights in terms of the debentures.<sup>274</sup>

#### 2.8.2.2.2.3 *Trust for debenture-holders as bewind trust*

In *Masterbond* the Court held that it was unnecessary to consider the *bewind* trust.<sup>275</sup> A *bewind* trust is a trust where the ownership of the trust property vests in the beneficiaries but control over the property vests in the trustee.<sup>276</sup> In *Masterbond* the applicant contended that both the security and the principal debt vested in the trustee, but the Court held that this had not been proved.

Olivier<sup>277</sup> makes the valid observation that if the real security rights in *Masterbond* did not vest in the trustee, as the Court found,<sup>278</sup> it must have vested in the debenture-holders. She argues that the difference between a *bewind* trust and agency is that in the former some transfer of ownership occurs to the beneficiaries, while control is vested in the trustee. There is no transfer of ownership under an agency.

In *Masterbond* it could not be convincingly argued that the principal debt had ever been *transferred* to the debenture-holders, since they were the creditors from the start. A cession of claims to the debenture-holders as beneficiaries under a trust is therefore necessary before a trust for debenture-holders is a *bewind* trust.

<sup>273</sup> Blackman *et al Commentary* at par 5-337 does not seem to identify this distinction.

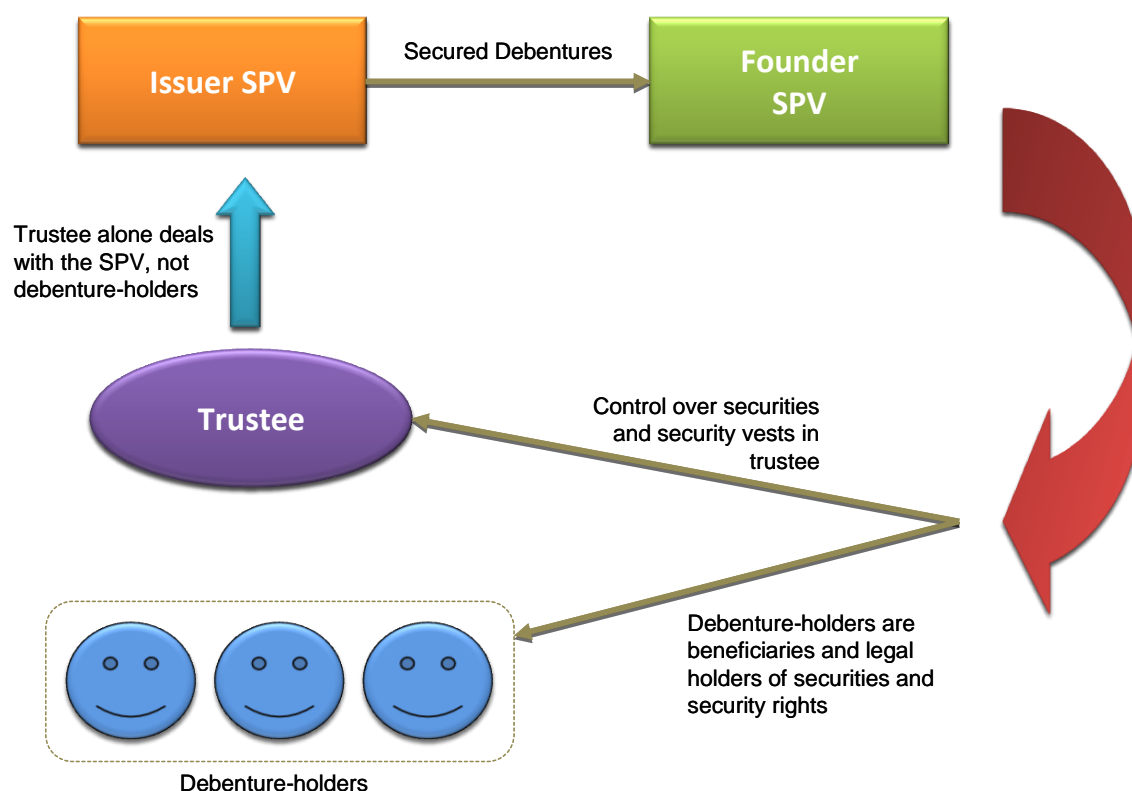
<sup>274</sup> The debenture trust will then be a *bewind* trust in terms of the Trust Property Control Act 57 of 1988. See par 2.8.2.2.2.3 below.

<sup>275</sup> *Conze v Masterbond Participation Bond Trust Managers (Pty) Ltd* 1996 (3) SA 786 (C) at 794F. See further Olivier 1997 *TSAR* at 767–771.

<sup>276</sup> See the definition of ‘trust’ in n 197.

<sup>277</sup> 1997 *TSAR* at 771.

<sup>278</sup> At 795B–C.



**Figure 4: *Bewind* trust construction of trust for debenture-holders**

It is possible to create a valid *bewind* trust for debenture-holders by introducing a second SPV into the structure to take up all the issued secured debentures.<sup>279</sup> The second SPV must then act as founder and transfer the debentures to the trust by vesting the debentures and their accessory security rights in the debenture-holders. Control over the debentures and the security rights vests in the trustee.<sup>280</sup> However, in order to comply with the accessory nature of the security rights, security will have to be in favour of the debenture-holders for registration purposes.<sup>281</sup> This means that the registration and transferability of the security is a problem under this construction, just as it was under the agency construction.<sup>282</sup>

<sup>279</sup> See Figure 4.

<sup>280</sup> There is academic debate in South African law whether security rights follow the principal debt automatically during a cession of those claims, or whether the co-operation of the security grantor must be obtained before such a transfer could occur. This debate is of lesser importance during the implementation of a scheme such as the one under discussion, since it would have been foreseen from the start of the transaction and the issuer SPV will co-operate in the transfer of the security rights to the debenture-holders. See par 7.2.3 on the accessory nature of real security rights.

<sup>281</sup> See n 229.

<sup>282</sup> See par 2.8.2.2.1.



This construction will have additional cost implications, because the securities must be transferred twice and the security rights might need to be registered twice. It will also not be possible to secure other transaction creditors during a securitisation scheme in this manner, which is possible with the use of a security SPV. Therefore, although this construction is possible, I do not recommend it and prefer the trust for debenture-holders as a true trust.

However, the use of the *bewind* trust construction for trusts for debentures-holders is preferable to the agency construction. The trustee will fall under the operation of the Trust Property Control Act, which will immediately provide additional protection for the debenture-holders. At the same time, although both the principal debt and the security vest in the debenture-holders, the control over the claims and over the security rights will vest in the trustee.

#### 2.8.2.2.2.4 *Trust for debenture-holders as true trust*

The founder of a trust may be a beneficiary of the trust, even the sole beneficiary.<sup>283</sup> I submit that the debenture-holders can cede their claims to the trustee for debenture-holders as founders immediately after acquiring the debentures, as a condition of the debenture.<sup>284</sup> This will qualify as a transfer of ownership in terms of the Trust Property Control Act.<sup>285</sup> The SPV may then grant security directly in favour of the trustee for debenture-holders, because the trustee will then also be creditor of the SPV. The debenture-holders will be beneficiaries. The debenture-holders' rights as beneficiaries vest immediately,<sup>286</sup> which means that those rights are transferable.<sup>287</sup> These rights are claims to payment of the principal debt and interest as determined by the conditions of issue of the debentures and strengthened by the terms of the trust deed. Furthermore, if the trust deed provides for this, it will be possible for other transaction creditors during a securitisation scheme also to cede their claims to the

<sup>283</sup> Cameron *et al Honoré's* at 553 and 173 *et seq.*

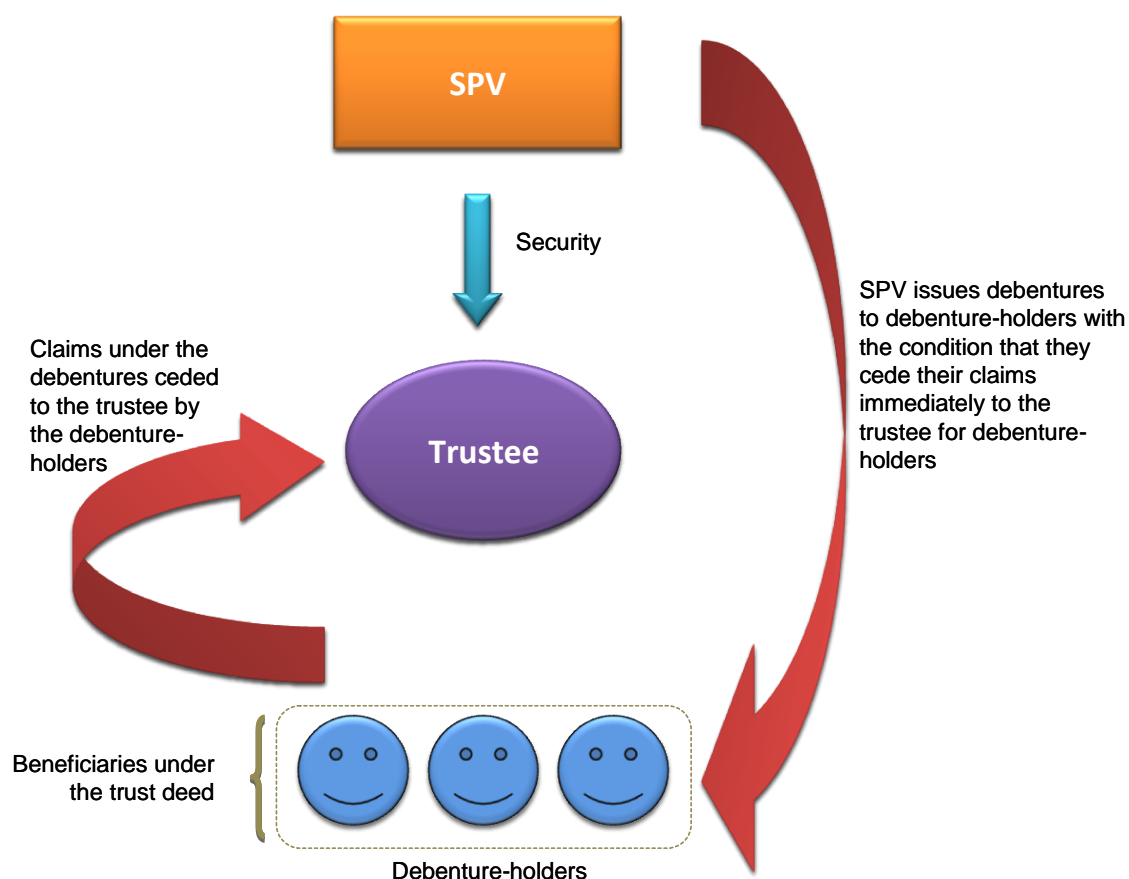
<sup>284</sup> See Figure 5.

<sup>285</sup> 57 of 1988.

<sup>286</sup> *Greenberg v Estate Greenberg* 1955 (3) SA 361 (A) at 364E–365D; *CIR v Sive's Estate* 1955 (1) SA 249 (A) at 261D; *Jowell v Bramwell-Jones* 1998 (1) SA 836 (W) at 872D–H. These cases dealt with the vesting of the interests of beneficiaries in trusts created by wills. However, the principles are the same for all trusts. See further Cameron *et al Honoré's* at 556.

<sup>287</sup> *Jowell v Bramwell-Jones* 1998 (1) SA 836 (W) at 872H; Cameron *et al Honoré's* at 557.

trustee. The security granted to the trustee will cover these claims too and priority will be provided for in the trust deed along similar lines as when a security SPV is used.



**Figure 5: True trust construction of trust for debenture-holders**

The true trust construction of the trust for debenture-holders is, in my opinion, the soundest. It provides the beneficiaries with the protection of the Trust Property Control Act. It does not involve elaborate schemes, such as the introduction of a second SPV and the separation of ownership and control. Security can be registered in the name of the trustee, which means that the potentially revolving nature of the beneficiaries will have no effect on their ranking nor will there be the burden of repeated registrations of security rights. There is no risk of revoked mandates, as is the case under the agency construction. Lastly, the trustee will be both the holder of the claims against the SPV and the holder of the security right, which conforms to the potential accessory nature of the security rights.

I would therefore strongly argue that in a normal issuance of corporate debt this construction of the trust for debenture-holders should be aimed for in the structuring

of the issuance of the debentures.<sup>288</sup> It is further my opinion that the same trust can be used to secure the claims of creditors other than the debenture-holders, as long as the trust deed provides for the transfer of their claims to the trustee and for the order in which the beneficiaries are entitled to payment.

### 2.8.2.2.3 *Trust for debenture-stockholders*

The trust for debenture-stockholders is the normal construction in English law<sup>289</sup> and is also possible in South African law.

In terms of this construction, the company, which will be the SPV, enters into a loan agreement with the trustee, which includes the terms of the payment of principal debt and interest.<sup>290</sup> Instead of debentures in serie, an issue of debenture stock is made and the debenture-stockholders receive debenture stock certificates to evidence their proportion of the loan amount. The trustee for debenture-holders is the creditor of the company and not the individual debenture-stockholders. This is so, even if the

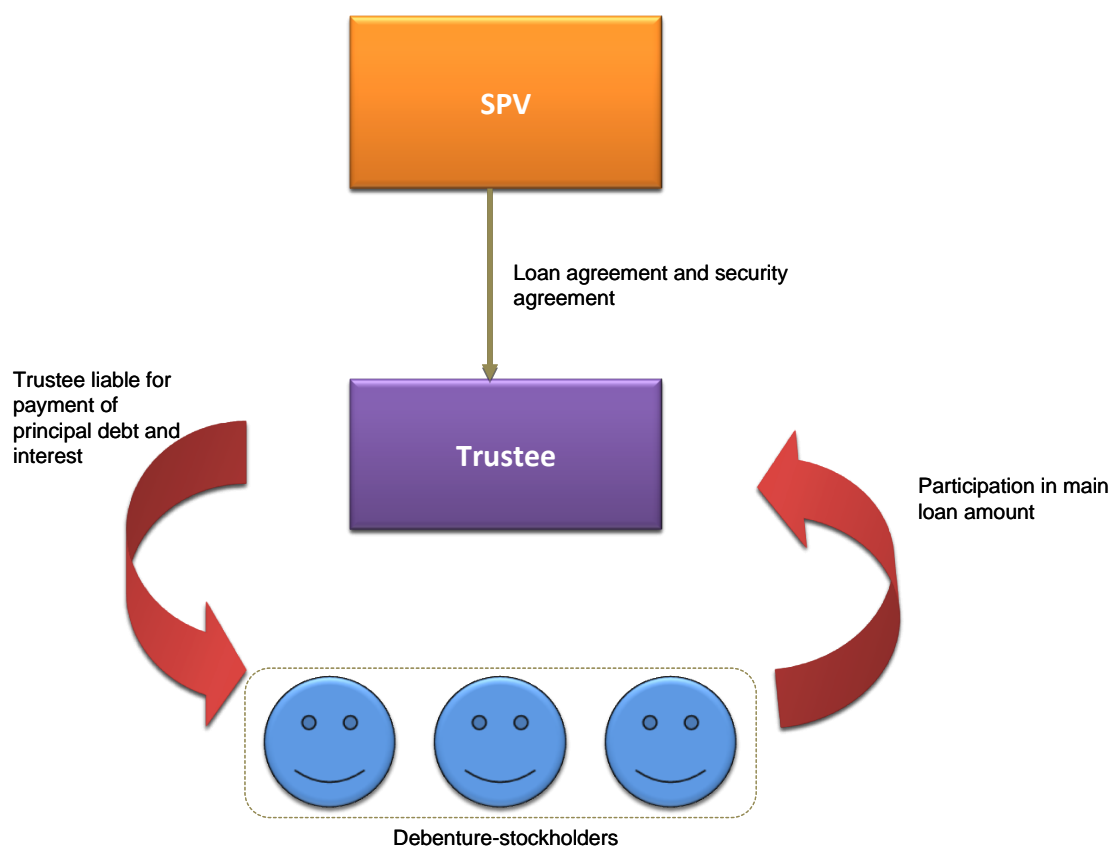
<sup>288</sup> Thiele *Collective Security Arrangements* at 19–25 identifies seven characteristics which, in her opinion, an effective collective security arrangement ought to have. The principles are (1) the possibility to create security without having to name or register the individual lenders that are to benefit from the security. This is possible in South Africa. See the discussion under pars 2.8.2.2.1 and 5.5.1 for the position at the Deeds Office. (2) The possibility to put one person in charge of monitoring and enforcing the security, subject to terms that are agreed in advance. (3) Lenders' rights in respect of the security and proceeds of the security must be properly protected. (4) Lenders' rights in respect of the security must be easily transferable. (5) Security should be capable of covering new loans, even if they are made by new lenders. Compliance with s 51 of the Deeds Registries Act 47 of 1937 read with s 120 of the Companies Act 61 of 1973 will satisfy this requirement. (6) It should be possible to replace the person in charge of the security without affecting the security. The Trust Property Control Act 57 of 1988 provides for the replacement of the trustee. Registration in terms of the Deeds Registries Act 47 of 1937 will have to be in the name of the trust, or in the names of the trustee for the time being. The appointment of a new trustee should not hamper the validity of the security under such circumstances. However, if the trustee is only an agent of the debenture-holders and the security is registered in his name, this requirement will not be satisfied. (7) The arrangement should be as simple and as straightforward as possible. The agency construction only satisfies the third requirement, but fails on the rest of the criteria. The *bewind* trust construction satisfies the second, third and sixth requirement. The true trust construction fulfils all of the criteria. The trust for debenture-stockholders satisfies all of the criteria, except possibly the third one. Some protection can be afforded to the debenture-stockholders in the agreements between the trustee and the debenture-stockholders, but the Trust Property Control Act 57 of 1988 does not apply to this construction. This means that the claims against the SPV and the security fall in the estate of the trustee.

<sup>289</sup> See Paul L Davies *Gower and Davies' Principles of Modern Company Law* 7 ed (2003) at 809–811; Thiele *Collective Security Arrangements* at 159 *et seq*; Fuller *Corporate Borrowing* at 117. It should be noted, however, that English law does not know the two forms of trust as it is set out in the South African Trust Property Control Act 57 of 1988, namely true trust and *bewind* trust. The practical effects of the two forms remain more or less the same: the trustee has control over the enforcement of the principal debt and interest payments and the rights under the security agreements. See further Rawlings 2007 *JBL* at 47.

<sup>290</sup> See Figure 6.

arrangement is that the company will make payments to the debenture-stockholders directly and not via the trustee for debenture-stockholders.<sup>291</sup> The debenture-stockholders have remedies against the trustee, but rarely against the company.

This construction achieves the same benefits as the true trust construction. The trustee is the holder of the claims and of the security rights. The trustee holds the security in his own right and consequently section 54 of the Deeds Registries Act<sup>292</sup> becomes irrelevant. It becomes unnecessary to look to legislative means to effect equal ranking between the debenture-holders, because they are all equal beneficiaries under the trust according to the size of their stock, regardless of when they acquired it.<sup>293</sup> The provisions of section 121(1) of the Companies Act<sup>294</sup> are also irrelevant to this construction. In terms of the trust deed, the debenture-holders will have no rights to enforce against the company, but will only have remedies against the trustee.<sup>295</sup>



**Figure 6: Trust for debenture-stockholders**

<sup>291</sup> Blackman *et al Commentary* at par 5-335.

<sup>292</sup> 47 of 1937.

<sup>293</sup> See s 120 of the Companies Act 61 of 1973.

<sup>294</sup> 61 of 1973. See par 2.8.2.1.3.1.

<sup>295</sup> See also Blackman *et al Commentary* at par 5-340.

However, it is very important to note that the trust for debenture-stockholders is not a trust in the strict sense in terms of current South African law.<sup>296</sup> The reason for this is that there is no transfer of ownership to the trustee, which is essential for the creation of a trust in terms of the Trust Property Control Act.<sup>297</sup> The loan agreement is between the trustee and the company (SPV), and the security is granted to him directly. The role of the debenture-stockholders is closer to that of sub-participants in a syndicated loan. They share the burden of the loan by virtue of an agreement with the trustee, but they have no agreement directly with the borrower (SPV).

If the Trust Property Control Act does not apply to this relationship, some of the protective measures as discussed above would not be available automatically. Some aspects, such as proper bookkeeping and accountability may be included in the agreement between the parties. However, the relationship will still fall outside the power of the Master of the High Court. Most importantly, the trust property will not be legally separated from the personal estate of the trustee. This will make the claims vulnerable to attachment by the creditors of the trustee's personal estate. The claims will also be available to the trustee's creditors in the event of his insolvency.

### 2.8.3 Trustee for debenture-holders<sup>298</sup>

The trustee for debenture-holders should preferably be independent of the company, which will be the SPV. The company's directors and officers are prohibited from

<sup>296</sup> English trust law was not received in South African law and forms no part of our law. See *Estate Kemp v MacDonald's Trustee* 1915 AD 491 at 499; *Braun v Blann and Botha* 1984 (2) SA 850 (A) at 859E–F. English trust law is premised on the basis of dual or divided ownership, where the legal estate in the trust property vests with the trustee and the equitable estate vests in the trust beneficiary. This duality was the result of the historical development of the trust, whereby courts have over centuries made concessions on behalf of the beneficiary of a trust to act against the trustee for breaches, even though the beneficiary had no proprietary interest in the trust property. The Chancellor awarded a remedy to such a party, especially if the absence of a remedy in common law brought about unjust or inequitable consequences. In time these concessions took the nature of proprietary interests rather than claims against the trustee. For more information on the historical development of trusts, see Du Toit *Trust Law* at 15–21; Cameron *et al Honoré's* at 24–29. This duality does not form part of our law (*Braun v Blann and Botha* 1984 (2) SA 850 (A) at 859E–F), but most of the benefits of that system have been introduced in the Trust Property Control Act 57 of 1988. An example is the separation of the trust property from the private estate of the trustee (s 12). However, some arrangements that would be considered trusts in English law might not comply with the statutory definition of trusts in South Africa. I would argue that the trust for debenture-stockholders is such a case.

<sup>297</sup> 57 of 1988.

<sup>298</sup> The aspects discussed in this paragraph apply to all trustees of debenture-holders, unless otherwise indicated. The relationship between the trustee and the servicer was commented on in par 2.7.

being trustees for debenture-holders.<sup>299</sup> It is further preferable that the trustee should not be a creditor of the company, as this may lead to a conflict of interests.<sup>300</sup>

The trustee owes a duty of care, diligence and skill to the debenture-holders as beneficiaries of the trust.<sup>301</sup> This is also the position when the trustee is an agent of the debenture-holders in terms of the agency construction.<sup>302</sup>

The standard of care that a trustee for debenture-holders must observe is not that which an ordinary person generally observes in the management of his own affairs, but rather that of the prudent and careful person.<sup>303</sup> Added to that, trustees for debenture-holders are usually professional persons or specialised institutions, which further increases the standard of care expected of them.<sup>304</sup>

The trust deed usually sets out the following duties and discretions of the trustee:<sup>305</sup>

- A specification of circumstances under which the security will become enforceable, such as default on the principal debt or interest payments. It is usually specified that only a default that will materially prejudice the debenture-holders will lead to enforceability. It is left to the trustee's discretion when a default is materially prejudicial.<sup>306</sup> Although the trustee does not have a duty to verify all reports made to him, he will have a duty to investigate a breach in order to determine its effect on the rights of the debenture-holders.<sup>307</sup>

<sup>299</sup> Section 122 of the Companies Act 61 of 1973.

<sup>300</sup> See Blackman *et al Commentary* at par 5-341; Fuller *Corporate Borrowing* at 125; Rawlings 2007 *JBL* at 50.

<sup>301</sup> Section 9(1) of the Trust Property Control Act 57 of 1988: "A trustee shall in the performance of his duties and the exercise of his powers act with care, diligence and skill which can reasonably be expected of a person who manages the affairs of another." See further Blackman *et al Commentary* at par 5-344 to 5-345.

<sup>302</sup> Kerr *Agency* at 136 *et seq.*

<sup>303</sup> Blackman *et al Commentary* at 5-345; Meskin *Henochnsberg* at 232; *Sackville West v Nourse* 1925 AD 516 at 534.

<sup>304</sup> Thiele *Collective Security Arrangements* at 169; Fuller *Corporate Borrowing* at 122; Rawlings 2007 *JBL* at 50. In the English decision *Bartlett v Barclays Bank Trust Co Ltd* [1980] 1 All ER 139 at 152 the Court held that: "a professional corporate trustee is liable for breach of trust if loss is caused to the trust fund because it neglects to exercise the special care and skill which it professes to have ... Trust corporations ... hold themselves out as possessing a superior ability for the conduct of trust business." If the trustee is a financial institution it must observe the utmost good faith and exercise proper care and diligence (s 2 of the Financial Institutions (Protection of Funds) Act 28 of 2001).

<sup>305</sup> O'Hagan 2000 *J of Int Trust and Corporate Planning* at 94. His summary pertains to trusts for debenture stockholders, which is the usual form in English law, but South African trust deeds will provide for the same matters. See further Fuller *Corporate Borrowing* at 120–121.

<sup>306</sup> Rawlings 2007 *JBL* at 57.

<sup>307</sup> *Ibid.*

- A provision that permits the company (SPV) and the trustee to alter or amend the terms of the deed without the consent of the beneficiaries (debenture-holders) where the trustee considers that such an amendment will not materially prejudice the interests of the debenture-holders, and where the alteration is to correct a manifest error, or if the alteration is of a minor or technical nature.
- An agreement that the company (SPV) will provide the trustee with specified information regarding the company's financial condition. This information need not necessarily be disclosed to the debenture-holders, thereby protecting the confidentiality of the company.<sup>308</sup> The transaction agreements might contain provisions that require the servicer to furnish the trustee with information regarding the state of collections and defaults.<sup>309</sup> The trustee is entitled to rely on the financial information provided to him, unless it appears that something requires further inquiry.<sup>310</sup> However, the examination of the accounts must be done with the standard of care set out above. The trustee must be allowed to use an independent auditor to inspect transactions that seem irregular.<sup>311</sup>
- Provisions that permit the trustee to give permission to the company (SPV) to deal with the secured property, as long as the trustee is satisfied that the debenture-holders will not be materially prejudiced.
- Provisions of the circumstances under which a meeting of debenture-holders will be called and rules regarding such meetings.

When the construction of the debenture trust is truly one of trust, the trustee does not need to consult with the debenture-holders before exercising any of the discretions given to him in the trust deed.<sup>312</sup> He need not follow their wishes nor provide them with reasons for his actions, unless the trust deed provides otherwise. However, in practice he will usually consult them if the matter is serious and if practicality allows for such a consultation. If the construction of the debenture trust is one of agency, the trustee will have no power to act outside the express mandate given to him by the

<sup>308</sup> See also Duffett 1992 *J of Int Planning* at 25.

<sup>309</sup> Gibson 2004 *Banking LJ* at 389.

<sup>310</sup> Fuller *Corporate Borrowing* at 124; Gibson 2004 *Banking LJ* at 390.

<sup>311</sup> Gibson 2004 *Banking LJ* at 405.

<sup>312</sup> Fuller *Corporate Borrowing* at 124.

debenture-holders and this will be reflected in the document that appoints the trustee as representative.

The independence of the trustee from the debenture-holders is especially important upon a default. It is here where the agency construction proves to be unworkable in the context of securitisation. After default the trustee's duties increase and he must immediately consider certain actions to protect the interests of the debenture-holders. Such action may include<sup>313</sup>

- increased monitoring and a review of servicing and collections;
- reviewing and enforcing credit enhancement;
- preparing for negotiations and possible insolvency; and/or
- if the originator is declared insolvent, three further tasks, namely
  - 1 ensuring that the claims are collected and that the SPV receives the proceeds;
  - 2 ensuring that the originator does not attempt to pass off the assets of the SPV as its own in an effort to gain new financing while in distress; and
  - 3 defending the nature of the transfer of the assets to the SPV as a true sale, in the event that the originator's liquidators claim that the assets belong to the estate of the originator.

Any provision in the trust deed or in the contract with the debenture-holders to the effect that the trustee shall not be liable for breach of trust or for failing to show the degree of care and diligence required of him as a trustee is void.<sup>314</sup> This means that a blanket approval of such breaches is not allowed. However, three-quarters in value of the debenture-holders may consent to a release from liability of a trustee with reference to specific acts or omissions.<sup>315</sup>

The trustee will be entitled to remuneration, which will be regulated by the trust deed,<sup>316</sup> or otherwise to a reasonable remuneration that may be determined by the Master of the High Court in case of a dispute.<sup>317</sup> The fee will depend on the scale of

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<sup>313</sup> Gibson 2004 *Banking LJ* at 392.

<sup>314</sup> Section 123(1) of the Companies Act 61 of 1973. See also Meskin *Henocheberg* at 231.

<sup>315</sup> Section 123(2)(a)(i) & (ii) of the Companies Act 61 of 1973.

<sup>316</sup> Cameron *et al Honoré's* at 351.

<sup>317</sup> Section 22 of the Trust Property Control Act 57 of 1988. This is of course only with respect to the trust construction. If the trustee is really an agent, he will have to negotiate his remuneration directly with the principal, in this case the debenture-holders.



the monitoring functions expected of him, which may be more in securitisation than those expected from a debenture trustee generally.<sup>318</sup>

## 2.9 DISTINCTION BETWEEN SECURITISATION AND OTHER FORMS OF STRUCTURED FINANCE

The structure I discussed in this chapter is the basis of a traditional asset-backed securitisation scheme. It involves the transfer of assets to an SPV and the financing of the transaction by way of the issuance of securities backed by those assets. In Chapter 1 I also briefly explained synthetic securitisation.<sup>319</sup>

However, the term ‘securitisation’ has different meanings for different people. The sale of participations or sub-participations in syndicated loans is sometimes referred to as ‘securitisation’.<sup>320</sup> Syndicated loans do not, however, involve an issue of securities as in a securitisation, although it may share some of the advantages of a securitisation.

Factoring is a financing method by means of which a company enters into an agreement with a third party (the factor) in terms of which the factor will administer the collection of the company’s debts.<sup>321</sup> The company invoices the client in the normal manner, but the invoice indicates that the claim was transferred to the factor and that only payment to the factor will discharge the claim. The factor pays a percentage of the value of the uncollected claims to the company on cession. When the claim is discharged, the remainder of the value of the claim is transferred back to the company. In return, the company pays the factor an administration fee, usually the equivalent of bank interest on the funds advanced by the factor.<sup>322</sup> There is a distinction between factoring with recourse and factoring without recourse. During factoring with recourse the client bears the risk that the debtor will default on the claims, whereas in factoring without recourse the factor bears this risk.<sup>323</sup>

<sup>318</sup> Gibson 2004 *Banking LJ* at 395.

<sup>319</sup> See par 1.1.

<sup>320</sup> See for instance Oditah *Global Securities Market* at 84.

<sup>321</sup> Tim Lea & Wendy Trollope *A Guide to Factoring and Invoice Discounting: The New Bankers* (1996) at 16. See further Nereus L Joubert *Die Regsbetrekkinge by Kredietfaktorering* (1985) at 35–49 where the author sets out the services that a factor will provide its client.

<sup>322</sup> Lea & Trollope *Factoring* at 17–18. There are many variations on this basic factoring model, but this explanation suffices in order to draw a comparison between factoring and securitisation.

<sup>323</sup> Joubert *Kredietfaktorering* at 50.

A number of differences between securitisation and factoring emerge from this brief description. The purpose of a factoring arrangement is to better the administration of the company's debt collection.<sup>324</sup> The company and the factor operate closely together. The company remains exposed to the risk of default by the debtors in recourse factoring. Even during non-recourse factoring the company still carries some of the loss in the event of default. More importantly, there remains a dependency between the factor and the client, because the continued use of a factor depends on the business prosperity of the client. During securitisation the aim is to insulate the SPV from the commercial risks of the originator. Factoring is considerably less complicated than securitisation and lends itself better to use by small and medium-sized enterprises.<sup>325</sup> However, the continued link with the business risks of the company means that the company will not achieve financing at a lower cost than it would if it had used bank loans. Securitisation, however, leads to financing at a lower cost.

After successful securitisation the originator should be totally divested of the risk associated with the transferred assets. The originator is no longer the owner of the transferred assets. There are other methods of transferring or diluting the risk associated with a particular group of assets, but they do not involve the transfer of assets to another person. The credit derivative is an example of such a transaction, whereby one party agrees to pay another or to receive from another the difference between the financial performance expected of a particular investment and its actual performance.<sup>326</sup>

Some authors refer to bond or commercial paper issues as securitisation.<sup>327</sup> However, a direct issue of debt does not achieve the central objective of securitisation, namely to insulate a specific pool of assets from the rest of the estate of the originator in order to achieve a better credit rating and, consequently, better interest rates. Consequently, in a normal bonds issue the investor is exposed to the business risks of the everyday operations of the company, while in securitisation the

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<sup>324</sup> Joubert *Kredietfaktorering* at 84–87.

<sup>325</sup> Lea & Trollope *Factoring* at 5–6.

<sup>326</sup> Glennie *et al Securitization* at 192. See Wood *Title Finance* at 207 *et seq* for a detailed discussion of swaps and derivatives.

<sup>327</sup> See, for instance, Haynes 2000 *European Business LR* at 39.

investor need only look at the risks associated with the performance by the debtors of the transferred claims.<sup>328</sup>

## 2.10 CONCLUSION

Securitisation offers many potential advantages, all of which follow from the structure of the scheme.<sup>329</sup> In this chapter I analysed the components of a typical traditional securitisation scheme as used in South Africa. Every component of the scheme is there to reduce the risk of default by the issuer SPV of its obligations towards the investors in the scheme.

The rating agency plays a particularly important role from the start of the transaction in evaluating every component and providing opinions on how to maximise the potential of the scheme to give optimal safeguards to the investors. At least one aspect of securitisation schemes in South Africa, namely the use of a security SPV rather than a trustee for debenture-holders, has been due to the influence of rating agencies. Even though rating agencies play such a significant role, I submit that regulation of rating agencies is unnecessary. South African common law is, in my opinion, resilient enough to ensure liability of rating agencies if they provide an inaccurate rating due to the negligent performance of their duties.<sup>330</sup>

However, I recommend that rating agencies could be certified as institutions that conform to sound methodology in their rating process. Such certification must not aim to prescribe the methods and procedures followed by rating agencies, but must evaluate the methods and procedures already in use against specified criteria. The publication of methods and procedures to an independent certification authority, which may be an exchange that regularly deals with debt instruments, for instance, the Bond Exchange of South Africa, would also encourage rating agencies to keep to those procedures and not to deviate from them without proper cause. This, in my opinion, will lead to greater investor confidence in the ratings provided by less-established rating agencies.

The structure of securitisation schemes in South Africa is similar to those used in the United States of America and in England, with the exception of the use of a trust

<sup>328</sup> See also Reis-Roy 1998 *J of Int Banking Law* at 298–299.

<sup>329</sup> Paragraph 2.2.

<sup>330</sup> See par 2.6 *et seq.*

for debenture-holders to secure the claims of the debenture-holders and other transaction creditors in the scheme. I therefore paid particular attention to this aspect of the structuring of a securitisation scheme.<sup>331</sup>

The use of a security SPV in South African securitisation schemes is a consequence of the insistence by rating agencies that transaction creditors involved in the securitisation scheme must agree not to apply for the winding-up of the SPV before two years after the final claims of the holders of the securities have been paid. These non-petition clauses reduce the risk of the insolvency of the SPV. However, transaction creditors are not willing to enter into such agreements, unless the SPV grants security in their favour over the assets of the SPV.

There is uncertainty in South African law whether a trust for debenture-holders as provided for in section 117 of the Companies Act<sup>332</sup> can hold security on behalf of creditors other than debenture-holders. South African securitisation schemes therefore avoid the trust structure altogether and opt for the security SPV in the form of a company.

I am of the opinion that the provisions in the Companies Act that deal with security for debentures are superfluous, and only lead to uncertainty and inefficiency.<sup>333</sup> The uncertainty lies in the fact that only debenture-holders are mentioned, when it ought to be possible to grant security in favour of a trustee for any creditor of a company. The inefficiency lies in the fact that neither the Deeds Registries Act<sup>334</sup> nor the Trust Property Control Act<sup>335</sup> mentions any of the provisions of the Companies Act that deal with trusts for debenture-holders. I submit that the provisions regarding security granted to a trustee for debenture-holders must be removed from the Companies Act and should only be regulated by the Trust Property Control Act.

I evaluated the security SPV currently in use in South African securitisations.<sup>336</sup> To date the guarantees provided by such security SPV have never been called up, which means that this security scheme has not yet been tested. Furthermore, as far as I am aware, the true sale of the assets by the originator to the issuer SPV has never been

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<sup>331</sup> Paragraph 2.8.2 *et seq.*

<sup>332</sup> 61 of 1973.

<sup>333</sup> Paragraphs 2.8.2 and 2.8.2.1.2.1.

<sup>334</sup> 47 of 1937.

<sup>335</sup> 57 of 1988.

<sup>336</sup> Paragraph 2.8.2.1.

put to the test in South African courts during the insolvency of an originator. I submit that even if this scheme is used, it will be beneficial to the interests of debenture-holders to make use of a trust for debenture-holders. The trustee for debenture-holders could then monitor the security SPV when the issuer SPV defaults on its obligations and the guarantee of the security SPV is called up in favour of the debenture-holders. The trustee can institute proceedings on behalf of the debenture-holders before the guarantee is called up or when the true sale of the assets is argued before a court during a liquidation of the originator.

I further considered what legal forms the trust for debenture-holders may take and which form provides most of the benefits of a trust for debenture-holders. My conclusion is that a true trust construction of a trust for debenture-holders is possible in South African law and would be most beneficial to the interests of the debenture-holders.<sup>337</sup>

In terms of the agency construction, the debenture-holders will not enjoy the protection that the provisions of the Trust Property Control Act afford.<sup>338</sup> The security will have to be registered in the names of the individual debenture-holders, which is not only inconvenient and impractical, but will restrict the transferability of the debentures. Furthermore, the debenture-holders as principals will have the power to revoke the mandate of the trustee to act on their behalf.

Owing to the requirement of the Trust Property Control Act that a transfer of ownership is necessary to constitute a trust, a trust for debenture-holders can only be a *bewind* trust if the debentures are created, and security for the debentures granted, in favour of an intermediary first.<sup>339</sup> The debentures and the security rights are then transferred to the debenture-holders, but the entitlement to enforce the debentures and the security is vested in the trustee. However, as was the position under the agency construction, registration of the security rights will then have to be in the names of the individual debenture-holders.

In terms of the true trust construction, the debenture-holders act as founders of the trust by transferring the debentures to the trustee immediately after acquiring them. Security for the claims is granted directly to the trustee. The disadvantages set out

<sup>337</sup> Paragraph 2.8.2.2.4.

<sup>338</sup> Paragraph 2.8.2.2.1.

<sup>339</sup> Paragraph 2.8.2.2.3.

above in relation to the other possible forms of the trust for debenture-holders are thereby avoided.

**PART II**  
**COMPARATIVE PERSPECTIVES**





## CHAPTER 3 ENGLISH LAW

### 3.1 INTRODUCTION

I briefly indicated the historical connection between English law and South African mercantile law in Chapter 1.<sup>1</sup> Owing to the fact that South African company law was originally based on English legislation, the development of English company law is important to consider when South Africa considers its own future company law development. Furthermore, the United Kingdom has the largest securitisation market in the European Union and the second largest securitisation market worldwide after the United States.

I start by providing an overview of the methods by which security can be granted over claims in English law. Of particular importance is the difficulty experienced in characterising a charge over book debts as a floating charge or as a fixed charge. I then discuss aspects of legislation that are particularly important for securitisation in England. Then I discuss assignment and the risk of recharacterisation of the securitisation transaction in English law. Finally, I evaluate the risk of a successful application by a liquidator of an insolvent originator to avoid the securitisation transaction in terms of current insolvency legislation.

### 3.2 LEGAL AND EQUITABLE CHARGES

English law draws a distinction between legal and equitable security.<sup>2</sup> It follows that there is a distinction between a legal mortgage and an equitable mortgage (security

<sup>1</sup> n 13 and 14.

<sup>2</sup> Until the enactment of the Supreme Court of Judicature Acts of 1873 (36 & 37 Vict c 66) and 1875 (38 & 39 Vict c 77) there were two parallel systems of law operating in England, each applying their own distinct rights and remedies. The Common Law Courts applied common law and the Court of Chancery applied equity. Rights and remedies nowadays described as 'equitable' were developed and enforced by the Chancery Courts. See in general Robert A Pearce & John Stevens *The Law of Trusts and Equitable Obligations* 3 ed (2002) at 3–31; Jill E Martin *Hanbury & Martin Modern Equity* 15 ed (1997) at 3–43. Martin *Modern Equity* at 4 provides the following abbreviated explanation of equity: "Equity is the body of rules which evolved to mitigate the severity of the rules of the common law. Its origin was the exercise by the Chancellor of the residual discretionary power of the King to do justice among his subjects in circumstances in which, for one reason or another, justice could not be obtained in a common law court." After the enactment of the Supreme Court of Judicature Acts, the High Court has jurisdiction in matters arising from common law and in equity (see s 18(2) of the Supreme Court of Judicature (Consolidation) Act 1925 (15 & 16 Geo c 49), which consolidated the previous legislation dealing with these matters).

over land and buildings). Charges are security over tangible movable assets, also called ‘chattels’, and all charges are enforceable only in equity.<sup>3</sup>

A legal mortgage is created by the transfer of an existing asset to a creditor in accordance with any statutory formalities.<sup>4</sup> The transferor’s title to the asset must be a legal and not an equitable title.<sup>5</sup> The security grantor may redeem or recover the legal title upon repayment of the debt. Although in form a legal mortgage is an absolute transfer subject to an equitable right of legal redemption on discharge of the secured obligation, in reality the substance of the ownership still remains with the security grantor, in other words, under English law a legal mortgage is a transfer of ownership as security.<sup>6</sup> A legal mortgage gives priority over subsequent real interests in the asset, whereas equitable mortgages and charges may be vulnerable to a subsequent disposition of the asset to a bona fide purchaser for value who had no notice of the equitable security interest.

It follows from these characteristics of a legal mortgage that equitable security may be created under the following circumstances:<sup>7</sup>

- Where the security relates to future property.
- Where there is no transfer of title nor an agreement to transfer, but merely a charge.
- Where there is no immediate transfer, but only an agreement to transfer in the future.
- Where the transfer is not made according to the formal requirements for the transfer of legal title (such as registration).<sup>8</sup>

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<sup>3</sup> WJ Gough *Company Charges* 2 ed (1996) at 18; Roy Goode *Legal Problems of Credit and Security* 3 ed (2003) at 8. As a result all charges are equitable security.

<sup>4</sup> For instance, for a legal assignment of receivables s 136 of the Law of Property Act 1925 (15 & 16 Geo 5 c 20) requires that the assignment must be in writing and that the debtor must be notified in writing of the assignment. However, notice to the debtor does not need to include a direction that the debtor must pay the assignee. For criticism of this situation, see Goode *Legal Problems* at 95.

<sup>5</sup> Goode *Legal Problems* at 8; Gough *Company Charges* at 16.

<sup>6</sup> See also Goode *Legal Problems* at 7 and 35. The existence of the equitable right to regain the asset in future would seem to preserve the company’s ownership of the asset. See Simon Goulding *Principles of Company Law* (1996) at 262.

<sup>7</sup> Goode *Legal Problems* at 8.

<sup>8</sup> These requirements vary according to the kind of asset given as security. For a full discussion of the requirements for the creation of legal mortgages on different kinds of assets, see Goode *Legal Problems* at 9–10.

- Where the transfer is not made to the creditor, but to a third party as trustee for the creditor.<sup>9</sup>
- Where the transferor's title to the asset is equitable, not legal.

A charge is an encumbrance over an asset (chattel) created by agreement and is enforceable only in equity.<sup>10</sup> A charge does not lead to a transfer of ownership nor does it confer an entitlement to possession and therefore it does not confer a right of foreclosure.<sup>11</sup> The chargee has the right of realisation through a judicial process, whether it is through an order of sale or through the appointment of a receiver.<sup>12</sup> There are no specific formalities for the creation of a charge. However, most charges in English law must be registered, thereby giving constructive notice of the existence of the charge.<sup>13</sup>

A further distinction is drawn between fixed and floating charges. A fixed charge is a charge over specified property and prevents the company from disposing of the property without the consent of the chargee.<sup>14</sup> This means that the company is not free to deal with the assets without the consent of the chargee.<sup>15</sup> This renders a fixed charge over objects such as stock-in-trade and book debts virtually impossible, because the company cannot survive if it cannot create cash flows from these assets. However, in theory it is possible to grant a fixed charge over a company's book debts.<sup>16</sup>

A floating charge is an equitable charge over some or all of the company's present and future assets where the company is free to deal with the assets in the ordinary

<sup>9</sup> As would be the case if a security is created in favour of a trustee for debenture-holders.

<sup>10</sup> Gough *Company Charges* at 18. In this chapter it is assumed that the chargor is a company and, more specifically, the SPV.

<sup>11</sup> Goode *Legal Problems* at 7 describes a charge as an encumbrance. Foreclosure is a remedy limited to mortgagees. See Goode *Legal Problems* at 152.

<sup>12</sup> Gough *Company Charges* at 19.

<sup>13</sup> Section 395 of the Companies Act 1985 c 6, ss 860 and 870(1) of the Companies Act 2006 c 46.

<sup>14</sup> Geoffrey Morse, Stephen Girvin, Richard Morris, Sandra Frisby & Alastair Hudson *Charlesworth Company Law* 17 ed (2005) at 504.

<sup>15</sup> In *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL) at 353D this was considered the most prominent difference between a floating charge and a fixed charge. In this case the charge was a floating charge regardless of the size and character of the security object, because the chargor could remove the security object from the charge without the consent of the chargee.

<sup>16</sup> See the discussion of Gerhard McCormack *Secured Credit Under English and American Law* (2004) at 211–217.

course of business.<sup>17</sup> Floating charges are by their very nature equitable security.<sup>18</sup> No legal title in the property is vested in the chargee. However, from the very moment of the creation of the charge a security exists and the chargee is capable of enforcing its remedies, regardless of whether the principal debt has become payable.<sup>19</sup>

The floating charge gradually evolved from the 1870s through judicial pronouncements on the nature of a charge over ‘the undertaking’. Its main aim is to safeguard the company from the paralysis caused by a fixed charge over its cash-generating assets.<sup>20</sup>

<sup>17</sup> Before the introduction of Article 9 of the Uniform Commercial Code, the position in the USA was that floating charges were not recognised as valid security. Freedom to deal with the charged assets in the ordinary course of business was seen as incompatible with the creation of a true security interest. Such a charge was seen as a fraud on the creditors of the company and void. See *Geilfuss v Corrigan*, 95 Wis. 651; 70 NW 306 (1897); *Benedict v Ratner*, 268 US 353; 45 S Ct 566; 69 LED 991 (1925). Revised Article 9 (1999) of the Uniform Commercial Code has been accepted by all the States, including Louisiana (see [https://www.incspot.com/pdfs/RA9QuickReferenceGuide2\\_04.pdf](https://www.incspot.com/pdfs/RA9QuickReferenceGuide2_04.pdf) (accessed 29 November 2005)). Section 9-205 of the Code provides as follows: “(a) A security interest is not invalid or fraudulent against creditors solely because: (1) the debtor has the right or ability to: (A) use, commingle, or dispose of all or part of the collateral, including returned or repossessed goods; (B) collect, compromise, enforce, or otherwise deal with collateral; (C) accept the return of collateral or make repossessions; or (D) use, commingle, or dispose of proceeds; or (2) the secured party fails to require the debtor to account for proceeds or replace collateral.” The official comment to this section states that the “Article expressly validates the ‘floating lien’ on shifting collateral ... this section repeals the rule in *Benedict v Ratner*, 268 US 353 (1925), and other cases which held such arrangements void as a matter of law because the debtor was given unfettered dominium or control over collateral.” This implies that although Article 9 draws no distinction between fixed and floating security interests, the concept of the floating charge is acknowledged. See also par 4.2.1.

<sup>18</sup> In other words the opposite of the definition of legal security as set out above. *Re Standard Manufacturing Co* [1891] 1 Ch 627(CA) at 645. This decision was followed in *In re Opera Ltd* [1891] 3 Ch 260 (CA). See also Gough *Company Charges* at 97.

<sup>19</sup> *Brunton v Electrical Engineering Corporation* [1892] 1 Ch 434 at 440; *Norton v Yates* [1906] 1 KB 112 at 122; Gough *Company Charges* at 98–99; Gavin Lightman, Gabriel Moss, Hamish Anderson, Ian F Fletcher & Richard Snowden *The Law of Administrators and Receivers of Companies* 4 ed (2007) at 55–56. Goode *Legal Problems* at 116–117 lists the following consequences of the fact that a floating charge is a present security: (1) Crystallisation causes the charge to attach without the need for any further act by the chargor (crystallisation is the process of conversion of the security from being floating in character to being specific or fixed, see pars 3.2.2.3 and 3.2.3); (2) On crystallisation the chargee may follow assets to third parties who received the assets beyond the ordinary course of business; (3) Restrictions on dealings with the charged assets (negative pledges) bind third parties taking with notice; (4) Crystallisation will lead to the chargee’s priority over an execution creditor who already obtained a writ of execution, but where the execution has not been completed; (5) The chargee may apply to court for the appointment of a receiver when his security is in danger, even when not seeking crystallisation and even if there has been no default.

<sup>20</sup> The earliest decisions that set out the general form of a floating charge were *Re Panama, New Zealand, and Australian Royal Mail Co* (1870) 5 Ch App 318; *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530; *Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) 15 Ch D 465 at 472; *Re General South American Co* (1876) 2 Ch D 337 at 344; *Re Hamilton’s Windsor Ironworks, ex parte Pitman and Edwards* (1879) 12 Ch D 707. The case most often cited for its definition of a floating charge is *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch 284 (CA) at 295: “I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge. (1) If it is a charge on a class of assets of a company present and

In practice a floating charge most commonly arises as security for a debenture, whether for a single debenture or for debentures issued in series under a trust.<sup>21</sup>

### 3.2.1 Characteristic elements of floating charges

Three characteristic elements of floating charges can be distinguished:<sup>22</sup>

- 1 The charge floats over the present and future property of the company so that it does not attach to any specific assets.
- 2 The company can assign the property as it pleases to third parties giving them good legal title, whether it is through sale or by way of security.<sup>23</sup>
- 3 The charge may ‘crystallise’ under certain circumstances, whereby it is converted from a floating charge into a specific or fixed charge.

These characteristic elements are used by the courts to determine whether a particular security is a fixed or a floating charge.<sup>24</sup>

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future; (2) if that class is one which, in the ordinary course of business of a company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that until some further step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with.” These decisions are collectively referred to as ‘the old authorities’ from here on. See also Robert R Pennington “The Genesis of the Floating Charge” (1960) 23 *Modern Law Review* 630; Gough *Company Charges* at 102; Goode *Legal Problems* at 112–113. See further *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 717–721 for a synopsis of the evolution of the floating charge. For a very interesting alternative opinion on the reasons for the development of the floating charge, see Roger Gregory & Peter Walton “Book Debt Charges: Following Yorkshire Woolcombers: Are We Sheep Gone Astray?” (2000) 4 *Insolvency Lawyer* 157 at 167. The authors regard the ban on future property security in the Bills of Sale Act 1882 coupled with the surge in company registrations as the true reason for the popularity of the floating charge - not a fear of trade paralysis.

<sup>21</sup> See Gough *Company Charges* at 88; *In re Brightlife Ltd* [1987] Ch 200.

<sup>22</sup> *Governments Stock and Other Securities Investment Co Ltd v Manila Railway Co Ltd* [1897] AC 81 at 86 per Lord MacNaghten in the House of Lords; *Illingworth v Houldsworth* [1904] AC 355 at 358 in the House of Lords by the same judge; *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch 284 (CA) at 295, where Lord MacNaghten made it clear that he did not intend to provide a definition in the *Manila* case, but merely intended a description. Also see Gough *Company Charges* at 85–86; Goulding *Principles* at 266; Morse *et al Charlesworth* at 505. These characteristics are accepted by most commentators and are therefore applied. However, Gregory & Walton 2000 *Insolvency Lawyer* at 163–165 are of the opinion that these characteristics were shared by what they refer to as a future personalty mortgage. This form of security granted fixed equitable security, characterised by the transfer of title and a right to possession (foreclosure). The authors also provide a list of precedents as examples of this form of security.

<sup>23</sup> This is referred to by some authors as the ‘business-dealing licence’.

<sup>24</sup> Owing to the high volume of registrations, it is impossible for the English Registrar of Companies to ascertain during the registration process whether a charge is truly fixed or floating in nature. The charge is therefore registered on the face of it, as long as the documentation is sound. It then remains for the receiver to convince the liquidator, creditors or the court that the charge is what it appears to be. See Nicholas Grier *UK Company Law* (1988) at 460.

A floating charge is not distinguished from a fixed charge because it encumbers future property, since it is also possible to encumber future property by way of a fixed charge. The distinguishing feature is rather that there is a ‘business-dealing licence’ between the chargor and the chargee.<sup>25</sup> If new property comes into the possession of the chargor, and it was the intention of the parties that such acquisition becomes a final and irrevocable appropriation of the property to the charge, so that the chargor cannot by a unilateral act decide that the property must be dealt with in a way that is inconsistent with the charge, it is a fixed charge and not a floating charge.<sup>26</sup> If the chargor can decide how to deal with the property, it is a floating charge.

A floating charge does not create a proprietary interest in any specific property of the company until it is crystallised. It does not fix or attach to any specific asset,<sup>27</sup> but rather ‘floats’ over a particular class of asset. The charge may be over all the assets of the company or its ‘undertaking’ or it may be over a nominated class of assets of the company, such as its machinery or book debts.

The nature of the charge is not determined by the frequency with which the assets move in and out of the estate of the chargor. Some of the assets that fall under the floating charge may pass through the estate swiftly (e.g. book debts) while others may ordinarily not be disposed of at all (e.g. machinery).<sup>28</sup>

<sup>25</sup> Gough *Company Charges* at 93; *Stein v Saywell* (1969) 121 CLR 529 (HC of Australia) at 556 (these comments were *obiter dicta* as they were not essential to the reasoning of the Court); *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142 (Ch) at 159; *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 719; Goode *Legal Problems* at 12 defines the difference between fixed and floating security in the following manner; “[a floating security] relates not to a specific asset but to an identifiable fund of assets, the debtor being authorised by the terms of the security agreement to dispose of all or any of the assets comprising the fund free from the security agreement.” In *Re Armagh Shoes Ltd* [1984] BCLC 405(Ch) at 408G–H the security was held to be a floating charge, even though it was called a fixed charge in the agreement.

<sup>26</sup> However, it was held in *Re Cimex Tissues Ltd* [1995] 1 BCLC 409 (Ch) at 420G–421A that a licence to deal with charged property to a limited extent (such as the replacement of outdated machinery) does not necessarily change the nature of the charge from a fixed to a floating charge. It will depend to a large extent on the wording of the charge agreement. Stephen Atherton & Rizwaan Jameel Mokal “Charges over Chattels: Issues in the Fixed/ Floating Jurisprudence” (2005) 26 *The Company Lawyer* 10 at 11–12 identify two considerations when a limited power to deal with the assets will still be in the nature of a fixed charge, namely (1) where the power is limited to where the assets are to be repaired or improved; and (2) where the power is one of substitution – the substituted assets will still fall under the fixed charge. See also Gough *Company Charges* at 94; Morse *et al Charlesworth* at 504.

<sup>27</sup> Goulding *Principles* at 265.

<sup>28</sup> Gough *Company Charges* at 111. See for instance *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL), where some of the assets held to be subject to a floating charge were huge washing plants used in the coal mining industry.

## 3.2.1.1 Charges over book debts

One specific area where the distinction between fixed and floating charges has received prominent attention is charges over the book debts of a company. The possibility of creating a fixed charge over the book debts of a company was affirmed in *Siebe Gorman & Co Ltd v Barclays Bank Ltd*.<sup>29</sup> However, in many cases a charge over the book debts of a company was held to be a floating charge, despite the contrary wording of the agreement.<sup>30</sup> The most common method of determining whether a charge over book debts is a fixed or a floating charge is to determine what would happen to the proceeds of the book debts after such proceeds have been received.<sup>31</sup> If the proceeds must be deposited into an account over which only the chargee has control, the charge is construed as fixed, because the chargor cannot deal with the assets freely. However, if there is no restriction on the use of the proceeds of the book debts by the chargor, the whole of the charge before and after the realisation of the book debts is considered to be floating.<sup>32</sup>

<sup>29</sup> *Siebe Gorman & Co v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 (Ch) at 159. Alan Berg "Charges over Book Debts: A Reply" (1995) *J of Business Law* 433 at 442–449 criticised the *Siebe Gorman* decision as at odds with the principle enunciated in *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284 (CA) that a specific charge gives the chargee possession and the entitlement to receive the book debts at once. This, in turn, may lead to business paralysis. Second, he argues that the main authority for the Court's decision, a British Columbia Court of Appeal decision *Evans, Coleman & Evans Ltd v RA Nelson Construction Ltd* (1958) 16 DLR (2d) 123 did not pay proper regard of the parties' subsequent conduct in the interpretation of the charge agreement, but only paid attention to the wording of the agreement itself. Berg's views have found approval in *Re Spectrum Plus Ltd National Westminster Bank plc v Spectrum Plus Ltd* [2004] 1 BCLC 335 (Ch D) at 351, after the Court decided to follow the implied criticism of the *Siebe Gorman* decision as enunciated in *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC). The Court of Appeal overturned this decision as being contrary to the doctrine of precedent, because it was bound by the Court of Appeal's decision in *Re New Bullas Trading Ltd* [1994] 1 BCLC 485 (CA); see *National Westminster Bank plc v Spectrum Plus Ltd* [2004] EWCA 670 at [43] and Alan Berg "Charges over Book Debts: The *Spectrum* Case in the Court of Appeal" (2004) *J of Business Law* 581. The House of Lords in *Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41 overturned the *Siebe Gorman* decision and unanimously held that the charge created in that case was in fact a floating charge. However, the possibility of creating a fixed charge over book debts was reaffirmed (at [80]).

<sup>30</sup> *Re Brightlife Ltd* [1987] Ch 200; *Re Permanent House (Holdings) Ltd* [1988] BCLC 563 (Ch); *Re GE Tunbridge Ltd* [1995] 1 BCLC 34 (Ch).

<sup>31</sup> *Morse et al Charlesworth* at 508–509. See also *In re Brightlife Ltd* [1987] Ch 200 at 209H: "Once in the account, they [the proceeds] would be outside the charge over debts and at the free disposal of the company. In my judgment a right to deal in this way with the charged assets for its own account is a badge of a floating charge and is inconsistent with a fixed charge."

<sup>32</sup> This was the method used in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 (Ch), now held by the House of Lords to have been a floating charge (*Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41). See also *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 722 and *Re Spectrum Plus Ltd National Westminster Bank plc v Spectrum Plus Ltd* [2004] 1 BCLC 335 (Ch). The emphasis is on whether the company is free to deal with the proceeds in the ordinary course of its business.

*Re New Bullas Trading Ltd*<sup>33</sup> considered the possibility of creating a fixed charge over the book debts of a company, but a floating charge over the proceeds of the charged book debts. The agreement between the parties in this case was that the proceeds had to be paid into a predetermined bank account. It further stated that if the chargee gave instructions to the company on the use of the account, the proceeds would remain under the fixed charge. In the absence of such instructions the proceeds would become subject to a separate floating charge. The chargee never gave instructions to the company on the use of the account. The Court *a quo* interpreted the whole charge as a floating charge using the argument explained in the previous paragraph. The Court of Appeal decided that effect should be given to the charge as it was described. This meant that the unrealised book debts remained subject to a fixed charge, but the proceeds were only subject to a floating charge.

The Court based its decision on a passage from *Re Yorkshire Woolcombers' Association Ltd*,<sup>34</sup> relied upon by the respondent, which reads as follows:

What you do require to make a specific security is that the security whenever it has once come into existence, and been identified or appropriated as security, shall never thereafter at the will of the mortgagor cease to be a security.

The Court then concluded that it was warranted to give effect to the agreement between the parties, because the proceeds did not cease to be subject to the fixed charge at the will of the company alone, but by mutual agreement between the company and the lender.<sup>35</sup>

The formulation of the security agreement in *Re New Bullas Trading Ltd* was intended to confuse the issue of priority. The parties intended to secure the best of two worlds: that the company could continue dealing with the assets, while the chargee fixes priority at the time of the registration of the fixed charge rather than at the crystallisation of the floating charge.<sup>36</sup> The decision was severely criticised by English and other Commonwealth commentators.<sup>37</sup>

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<sup>33</sup> *Re New Bullas Trading Ltd* [1994] 1 BCLC 485 (CA).

<sup>34</sup> *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284 (CA).

<sup>35</sup> At 429 C–D. In *Re Cimex Tissues Ltd* [1995] 1 BCLC 409 (Ch) at 426D–H the Court considered this to be the crucial point of the *Re New Bullas Trading Ltd* decision. Here the Court held (although in an *obiter dictum*) that the agreement may not be shaped so freely that the result is a charge unknown to law, by implication criticising the *Re New Bullas Trading Ltd* decision.

<sup>36</sup> Many commentators mentioned this consequence; see Roy Goode “Charges over Book Debts: A Missed Opportunity” (1994) 110 *Law Quarterly Review* at 602; Gerard McCormack “The Nature of



The Privy Council expressly overruled *Re New Bullas Trading Ltd* in a case hereafter referred to as the *Brumark* decision.<sup>38</sup>

In *Brumark* the facts were substantially the same as in *Re New Bullas Trading Ltd*. The debenture deed showed so much similarity to that in *Re New Bullas Trading Ltd* that both the Court of Appeal and the Privy Council observed that it must have been

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Security Over Receivables” (2002) 23 *The Company Lawyer* at 90, although the latter author seems to accept this consequence provided that it is done by way of legislation, for instance, by limiting the priority of all security on circulating assets; Sarah Worthington “Fixed Charges over Book Debts and other Receivables” (1997) 113 *Law Quarterly Review* at 568. Referring to this effect of the charge, Lord Walker of Gestingthorpe says the following in *Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41 at [141]: “Whether or not it is appropriate to describe this by some disparaging term such as camouflage, it is the court’s duty to characterise the document according to the true legal effect of its terms ... In each case there is a public interest which overrides unrestrained freedom of contract.”

<sup>37</sup> Goode 1994 *LQR* 592 at 604 criticises the judgment for a lack of understanding of the nature of a charge over future property. The nature of the charge remains constant and future property falls into the realm of that charge as it comes into the estate of the debtor. To treat the nature of the charge over the proceeds of the claim as distinct from the claim would mean that the security agreement over the proceeds will be contingent until the proceeds are collected. It follows that when the proceeds are collected a new security agreement will come into existence together with a freshly executed consideration. Priority will rank from the time that these requirements are met and not from the time of the original security agreement over the claim. The registration requirements of s 395 of the Companies Act 1985 (ss 860 and 870(1) of the Companies Act, 2006) will only be triggered after the new charge has been created which will mean that third parties will have no notice of it. Lastly, since no new value is given for the new charge it may be construed as a voidable preference under s 239 of the Insolvency Act 1986 c 45. For all these and other reasons, Goode argues that security over claims should rather be seen as continuous security over both the claim and its proceeds. See also Worthington 1997 *LQR* at 567–568; Lightman *et al Administrators* at 66–71. Berg 1995 *J of Business Law* at 449–462 supports *Re New Bullas Trading Ltd*. The author disagrees with Goode’s single continuous security construction. In his opinion, it is possible to create different charges on the book debt and its proceeds, because the two are different assets in the estate of the chargor. If the charge agreement states that the proceeds will fall under a previously created floating charge, a new charge will not be created, as Goode argues, but will simply fall under the existing floating charge. Berg would thus give effect to the agreement as it stood. He does agree, however, that a general charge over a company’s present and future book debts that does not prohibit a company from dealing with the proceeds of the book debts will seldom be held to be a fixed charge. To hold otherwise will lead to the paralysis of the company (see par 3.2.2.1), which is in Berg’s view the main mischief that a floating charge seeks to avoid on a proper reading of *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch 284 (CA). Also in support of *Re New Bullas Trading Ltd* is McCormack *Secured Credit* at 218–219. He argues that there is value in book debts, apart from their collection, in the possibility to sell them on. Second, there have been a number of contexts where English courts have considered book debts and their proceeds as separate assets. Last, if debts are assigned in contravention of a contractual prohibition on the assignment of the debts it does not prevent an assignee from having to account to the assignor for the proceeds of the debt. This suggests that the Court views the book debts and the proceeds separately. Elsewhere Goode has acknowledged the possibility of creating a floating charge over book debts and a fixed charge over their proceeds, but not the other way round (Goode *Legal Problems* at 127). See also *Re CCG International Enterprises Ltd* [1993] BCLC 1428 (Ch) at 1435 where the insurance money paid out in respect of a fire that destroyed the assets under a floating charge was held to fall under a fixed charge.

<sup>38</sup> The matter was referred to the Privy Council from New Zealand; *Commissioner of Inland Revenue v Agnew* (1999) 19 NZTC 15, 159; *Commissioner of Inland Revenue v Agnew* (2000) 1 NZLR 223 (CA); *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC).

drafted with a view to taking advantage of that decision.<sup>39</sup> In the Court of Appeal the Court held that this mode of drafting attempted to provide the lender with the greater security of a fixed charge, while affording the borrower the freedom of a floating charge.<sup>40</sup> Without coming to a definite conclusion as to whether it is possible to separate the uncollected book debts from their proceeds for the purposes of security, the Court held that the arrangement led to the conclusion that the book debts were not under the control of the chargee and therefore not in the nature of a fixed charge, but rather in the nature of a floating charge.<sup>41</sup> This decision was confirmed on appeal by the Privy Council.

The Privy Council held that it made no difference that in *Brumark* the proceeds of the book debts ceased to fall under the fixed charge when collected, while in *Re New Bullas Trading Ltd* the funds were not released until they were actually received in the company's bank account. The claims in both cases ceased to exist.<sup>42</sup> The Court drew a comparison between book debts and stock-in-trade. Both are part of the company's circulating assets. Neither falls in the owner's estate for his own enjoyment. They provide their owner with cash flow through realisation and, as such, form obvious objects for a floating charge.

The Court rejected the argument raised in *Re New Bullas Trading Ltd* that the parties were free to form whatever agreement they preferred and that the characterisation of the charge was therefore only a matter of construction. The Court held that the classification of a charge as fixed or floating is a two-stage enquiry. First, the charge agreement is examined to determine what rights and duties the parties intended to confer on each other. Thereafter, the categorisation of the charge is a matter of law, untouched by the intention of the parties. During this second stage the Privy Council regarded *control* of the charged assets as the pivotal aspect to be evaluated to determine the nature of the charge.<sup>43</sup>

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<sup>39</sup> *Commissioner of Inland Revenue v Agnew* (2000) 1 NZLR 223 (CA) at 224; *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 716.

<sup>40</sup> At 230.

<sup>41</sup> At 232.

<sup>42</sup> At 725.

<sup>43</sup> At 726. This two-staged approach in the characterisation of charges has since been applied in *Re Spectrum Plus Ltd National Westminster Bank plc v Spectrum Plus Ltd* [2004] 1 BCLC 335 (Ch D) and in *Ashborder BV v Green Gas Power Ltd* [2004] EWHC 1517 (Ch). It is also encouraged by *Goode Legal Problems* at 116.

The chargee does not by merely prohibiting assignment, factoring and further charges gain sufficient control over the charged assets to create a fixed charge. The Court held that alienation and collection were merely different ways of realising the debts, collection being the ordinary method. It then criticised as unsound the examples used in *Re New Bullas Trading Ltd* of fixed charges that were defeasible at the will of the chargor.<sup>44</sup>

The Privy Council examined questions raised by academic commentators on whether a book debt can be separated from its proceeds, whether a book debt and its proceeds represent one security interest or two, and whether a charge on a book debt necessarily creates an indivisible charge, regardless of the drafting of the agreement.

A book debt and its proceeds represent different assets in the estate of the company. However, the value of a book debt can only be exploited if the right is exercised (i.e., if it is collected), or if it is assigned for value to a third party. An assignment of a book debt that does not carry with it the right to receive the proceeds is valueless. It will also be worthless as security. The Court held that even if it was conceptually possible to separate the ownership of the book debts from the ownership of the proceeds, this would make no commercial sense.<sup>45</sup> But it appears that the Court saw the possibility of creating separate charges on the book debts and on the proceeds. If the company is at liberty to remove the assets under the fixed charge when it pleases, in this case by collecting the book debts, the charge on the book debts will still be categorised as a floating charge.<sup>46</sup>

<sup>44</sup> At 727–728. Although *Re Atlantic Computer Systems plc* [1992] Ch 505 and *Re Atlantic Medical Ltd* [1993] BCLC 386 (Ch) held that it was possible to create a fixed charge over receivables while the chargor could continue to collect and use the proceeds in the ordinary course of its business, these decisions have been criticised. The Court in *Royal Trust Bank v National Westminster Bank plc* [1996] 2 BLCL 682 (Ch) at 696 followed these decisions, but the Court of Appeal in an *obiter dictum* considered such a power inconsistent with the nature of a fixed charge. See *Royal Trust Bank v National Westminster Bank plc* [1996] 2 BLCL 699 (CA) at 706. Goode 1994 *LQR* 592 at 598–599 argues that the character of the charge as fixed or floating cannot be divorced from the contractual provisions of the application of the proceeds of the claims. McCormack 2002 *The Company Lawyer* 84 at 89 further argues that these cases are unsound on the basis that they do not comply with the conditions stated in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142 (Ch) before a fixed charge over book debts can be upheld. See also Worthington 1997 *LQR* at 566–567; Berg 1995 *JBL* at 463–465; Lightman *et al Administrators* at 70.

<sup>45</sup> At 729.

<sup>46</sup> McCormack 2002 *The Company Lawyer* 84 at 88 praises *Brumark* as a proper consideration of the legal and policy considerations surrounding the characterisation of charges. See also David Milman “Company Charges: A Return to Harsh Reality” (2001) 4 *Insolvency Lawyer* 135 who warns that in future the security agreement will have to contain restrictions upon collection of the claims if the charge is to be viewed as fixed.

The judgment of the House of Lords in *Spectrum Plus Ltd v National Westminster Bank plc*<sup>47</sup> affirmed *Brumark* and brought some certainty to the characterisation of charges. The charge before the Court was in the same form as the one created in *Siebe Gorman & Co Ltd v Barclays Bank Ltd*<sup>48</sup> and was indeed modelled on that charge. The *Siebe Gorman* charge agreement determined that the proceeds of the charged book debts had to be paid into the company's current account with the chargee bank. However, the company had unrestricted access to the current account and its linked overdraft facility. That charge was nevertheless held to be a fixed charge. Since then banks have used the *Siebe Gorman* precedent in the creation of their fixed charges, although it was only a decision by a lower court.

The Court *a quo* in *Spectrum Plus* decided not to follow the *Siebe Gorman* decision in the light of the Privy Council's decision in *Brumark*.<sup>49</sup> This was overturned by the Court of Appeal, which found that it was bound by its decision in *Re New Bullas Trading Ltd*.<sup>50</sup>

In the House of Lords the most in-depth consideration of the topic of characterisation of the charge was given by Lord Scott of Foscote, with whom all the other Lords concurred.<sup>51</sup> His lordship considered *Re New Bullas Trading Ltd* as a direct consequence and elaboration of the *Siebe Gorman* decision.<sup>52</sup> His criticism of the one decision should then also be seen as levied against the other. The other two judgments on this issue lent their support to *Brumark* and should also be seen as dissenting from the views in *Re New Bullas Trading Ltd*.<sup>53</sup>

The account in which the proceeds of the book debts had to be paid was held to be a normal current account coupled with an overdraft facility. The first important finding is that the bank acted as the client's agent in the latter's drawing of cheques

<sup>47</sup> *Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41.

<sup>48</sup> *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142 (Ch).

<sup>49</sup> *Re Spectrum Plus Ltd National Westminster Bank plc v Spectrum Plus Ltd* [2004] 1 BCLC 335 (Ch).

<sup>50</sup> *National Westminster Bank plc v Spectrum Plus Ltd* [2004] EWCA 670. For criticism of this decision see Berg 2004 *JBL* at 590–595 and 598–605; Sarah Worthington "An 'Unsatisfactory Area of Law': Fixed and Floating Charges Yet Again" (2004) 1 *International Corporate Rescue* 175.

<sup>51</sup> The other main legal question was whether the House of Lords could overrule a previous decision with only prospective effect.

<sup>52</sup> At [86]. This approach may have been in response to that of the Court of Appeal, where it found itself bound to *Re New Bullas Trading Ltd*; *National Westminster Bank plc v Spectrum Plus Ltd* [2004] EWCA 670 at [58].

<sup>53</sup> Lord Hope of Craighead at [56] and Lord Walker of Gestingthorpe at [151].

against that account.<sup>54</sup> The bank was bound to honour its client's cheques for as long as the account was in credit or until the overdraft limit was reached. The bank could not refuse to honour such cheques before its relationship with its client was terminated. It made no difference whether the account was in debit or in credit as long as the client could draw on the account.<sup>55</sup>

Lord Scott continued with a brief description of the evolution of the floating charge and of the statutory provisions that attempted to limit its far-reaching consequences.<sup>56</sup> None of these statutes defines 'floating charge' and the term must therefore be developed through judicial process. However, in so doing the courts must have regard to the aims of these limiting statutory provisions, specifically that the preferential creditors of the company should, in winding-up, be paid from the floating charge assets in priority to the floating charge.<sup>57</sup>

His lordship proceeded with an overview of the development of the characterisation of charges. He agreed with the Privy Council in *Brumark* that the third of the characteristics set out in *Re Yorkshire Woolcombers' Association Ltd*,<sup>58</sup> namely that until some further step is taken by the chargee, the chargor is free to conduct its business in the ordinary manner as regards the class of assets falling under the charge, lends a floating charge its distinctive character.<sup>59</sup> In the light of this finding, his lordship agreed that the charge created in *Re New Bullas Trading Ltd* was a floating charge. He described the distinction between the book debts and their proceeds where the proceeds were only subject to a floating charge as "an internal contradiction in the formulation of the charge".<sup>60</sup> His lordship held that the essential value of a book debt as security lay in the money that might be obtained in realisation.

<sup>54</sup> At [59] and [82]. At [158] the Court stated that in normal bank charges there will be at least three documents that may need to be interpreted in order to ascertain the true commercial reality of the relationship between the bank and the client, namely (1) the debenture creating the charge, (2) the bank's facility letter offering a term loan or an overdraft and (3) the bank's general terms and conditions.

<sup>55</sup> At [116].

<sup>56</sup> At [95] – [98].

<sup>57</sup> Section 175(1) of the Insolvency Act 1986.

<sup>58</sup> *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284 (CA) at 295.

<sup>59</sup> At [107] and [111]. The House of Lords thereby lent its approval to the *obiter dictum* in *Royal Trust Bank v National Westminster Bank plc* [1996] 2 BLCL 699 (CA) at 706 and disapproved of the line of reasoning followed in cases such as *Re Atlantic Computer Systems plc* [1992] Ch 505 and in *Re Atlantic Medical Ltd* [1993] BCLC 386 (Ch) that the ambulatory nature of the encumbered assets are paramount and that dealing with those assets is not inconsistent with a floating charge.

<sup>60</sup> At [110].

Therefore, a charge over book debts would only be characterised as a fixed charge if the chargee gains effective control over the proceeds. Where the chargee was a bank and the payments must be deposited in an account of that bank, it would only be a fixed charge if restrictions were imposed on the chargor's use of that account.<sup>61</sup> In the absence of such measures, as was the position in the present case, the charge would only be a floating charge.<sup>62</sup>

It seems then that the use of fixed charges over book debts will rarely occur.<sup>63</sup> A charge that provides for the proceeds of the book debts to be paid into a blocked account would not be very attractive to the company, which usually needs the cash from the proceeds of book debts to operate its business.<sup>64</sup> Nor would a floating charge over book debts be an attractive option for lenders, since charges over book debts will mostly provide the chargee with only weak priority over the claims of other creditors in insolvency and will be subordinated to preferential creditors before insolvency.<sup>65</sup> This makes the use of book debts as security objects for charges an unattractive option. This disadvantage is amplified if book debts constitute the majority of the company's assets potentially available as security.

### 3.2.2 Implied terms of floating charge agreements

Freedom of contract is a fundamental principle of English common law underlying its commercial law.<sup>66</sup> Parties' freedom to bind themselves as they choose is only curtailed

<sup>61</sup> At [140] Lord Walker of Gestingthorpe puts it as follows: "But if the terms of the debenture were such as to require the trader to pay all its collected debts into the bank and to prohibit the trader from drawing on the account (so that the account is blocked), a charge on debts, described as a fixed or specific charge, would indeed take effect as such." It is also not enough for the debenture to provide for such a blocked account if it is not in fact operated as such. See also at [159].

<sup>62</sup> At [116].

<sup>63</sup> This view is shared by Worthington 2004 *Int Corporate Rescue* at 182–183.

<sup>64</sup> Berg 2004 *JBL* at 611–612 makes a suggestion for overcoming the effect of paralysis of the company through the use of a fixed charge. He suggests the use of the blocked account method, but to include a provision where the company may, after 45 days of commencement of the debenture and ending 90 days thereafter, request the bank to waive compliance with the covenant to pay the proceeds into the blocked account and that the proceeds will henceforth only fall under a floating charge. Keeping in mind the reasoning employed by the House of Lords, I cannot see such a charge avoiding characterisation as a floating charge.

<sup>65</sup> See par 3.2.6 below.

<sup>66</sup> Gough *Company Charges* at 35–36. See Roy Goode *Commercial Law* 3 ed (2004) at 8: "Commercial law is the branch of law which is concerned with rights and duties arising from the supply of goods and services in the way of trade." The author continues at 10: "the foundation on which commercial law rests is the law of contract." See further Robert Bradgate *Commercial Law* 3 ed (2000) at 6, who describes party autonomy as an underlying feature of commercial law. See further at 35–37, where the author explains that the essential principles of contract law were developed in the eighteenth and

to the extent that legislative measures for the protection of the public restricts the terms on which parties may agree. The task of the courts is to interpret the intention of the contracting parties. This is specifically true with regard to the determination of the point at which the proprietary interest in the goods is assigned and becomes vested in the assignee.

There is no prescribed manner in which to create a floating charge. Agreement between the parties to create a charge over the business of the debtor or of the company as a going concern is enough to create a floating charge.<sup>67</sup> It must also be the intention of the parties that the chargee will not interfere with the carrying on of the business of the chargor as long as the charge remains floating.<sup>68</sup> This must be their true intention and the court will not only look at the use of specific words in the document.<sup>69</sup>

The earliest cases essentially interpreted business continuance, business-dealing licence and certain crystallisation terms as implied terms of a contract creating a charge.<sup>70</sup> This was done for ‘business efficacy’, so as to make the contract ‘workable’.<sup>71</sup> The aspects discussed below are therefore implied terms of a floating charge agreement. This means that in the absence of any express provisions to the contrary in the charge agreement, the following would be the norm:

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early nineteenth centuries, and were to a great extent influenced by the belief that parties were free to promote their own economic self-interest. Courts did not lightly interfere in contracts.

<sup>67</sup> *Re Panama, New Zealand, and Australian Royal Mail Co* (1870) 5 Ch App 318 at 322; *Wallace v Universal Automatic Machines Co* [1894] 2 Ch 547 (CA) at 554 per Lord Kay; *Re Florence Land and Public Works Co, ex p Moor* (1878) 10 Ch D530 at 540–541, 546. The *Wallace* decision also held that debentures become immediately payable and the floating charge immediately enforceable at the winding-up of the company (at 554), even if no provision was made for this in the agreement, since the possibility of the company continuing as a going concern ceases to exist. The earlier case of *Hodson v Tea Company* 14 Ch D 859 was approved and followed. See also *Gough Company Charges* at 88; *Davies Gower and Davies’ Principles* at 819.

<sup>68</sup> *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 at 987, 993; *Re Florence Land and Public Works* (1878) 10 Ch D 530 at 540–541, 547; *Wheatley v Silkstone and Haigh Moor Coal Co* (1885) 29 Ch D 715 at 718–719 as approved in *Evans*; *Hubbuck v Helms* (1887) 56 LJ Ch 536 at 537. The charge is either fixed or floating. It cannot be both at the same time. The last-mentioned two cases considered the granting of security over assets of the company before the charge became fixed. This is possible, because it falls within the normal business operations of the company. In *Helms* the security was not given in the ordinary course of business (at 538), but was rather a disguised sale of the business and as such was disallowed in favour of the debenture-holders.

<sup>69</sup> See *Gough Company Charges* at 89.

<sup>70</sup> *Gough Company Charges* at 176. More recent authority for this view can be found in *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 375.

<sup>71</sup> *Re Brightlife Ltd* [1987] Ch 200 at 212–213.

### 3.2.2.1 Business continuance

The courts have interpreted a ‘floating charge’ as leaving the chargor with the ability to carry on freely with its business, because the opposite would lead to the paralysis of the business.<sup>72</sup> The business would stop for two related reasons:

- 1 *Cash constraints*: the company would be unable to access its cash funds to use in the ordinary course of business. Even the money advanced under the charge would fall under the charge and become worthless for the company. Furthermore, it would become impossible for the company to take loans from other sources, because the money so advanced would also fall under the charge. Any person who receives money from the company with notice of the charge would be liable to repay it to the chargee.<sup>73</sup> The availability of cash or the possibility of attaining short-term finance is necessary for the purchase of stock, payment of ordinary business liabilities and payment of wages. Without it a business cannot continue.<sup>74</sup>
- 2 *If the charge were treated as fixed rather than floating, the consent of the chargee – often the debenture-holders – would have to be acquired before the company could deal with its assets.* Suppose the assets encumbered by the fixed charge were the stock-in-trade of the company. The company would require the consent of the chargee to sell the stock-in-trade to customers, effectively paralysing the business of the company.<sup>75</sup> If new stock-in-trade came into the possession of the chargor, a new fixed charge would have to be registered. Consent to deal with its stock-in-trade or to collect the book debts owed to it would administratively be so burdensome that the company would collapse.<sup>76</sup>

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<sup>72</sup> Gough *Company Charges* at 90.

<sup>73</sup> Gough *Company Charges* at 91.

<sup>74</sup> *Re Hamilton’s Windsor Ironworks, ex p Pitman and Edwards* (1879) 12 Ch 707 at 712.

<sup>75</sup> *Biggerstaff v Rowatt’s Wharf Ltd* [1896] 2 Ch 93 (CA) at 101; *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch 284 (CA) at 296; *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800 at 805–806; *Re Lin Securities Pte* (1988) 2 MLJ 137 at 142; *Re Florence Land and Public Works Co, ex p Moor* (1878) 10 Ch D 530 at 541. See also Geoffrey Morse *Palmer’s Company Law* (1992) at § 13.123.1: “The utility of a floating charge is that it removes the need for an endless series of deeds of substitution and release.”

<sup>76</sup> Gough *Company Charges* at 92.



### 3.2.2.2 Business-dealing licence

The business-dealing licence entails that the chargee, during the floating phase of the charge, has no right to interfere or intervene in any particular dealing by the chargor.<sup>77</sup>

A classic example of a statement by the court that led to the acceptance of this as an implied term of a floating charge agreement reads as follows:<sup>78</sup>

[The floating charge] shall be a security on the property of the company as a going concern, subject to the powers of the directors to dispose of the property of the company *while carrying on its business in the ordinary course* (my emphasis).

Gough<sup>79</sup> shows that the phrase ‘in the ordinary scope of business’ was not interpreted by the earliest cases as being a limitation on the right of the company to deal with its property freely. The courts used this phrase and ‘do with the property as the chargor thinks fit’ interchangeably, often together in one paragraph,<sup>80</sup> in other words, the company may deal with its assets in any manner that the powers of the company allow. The only limitation on transactions by a company during the existence of a floating charge is that the company must be able to carry on as a going concern after the particular transaction.

The scope of the transactions that a chargor may enter into under this implied licence, or under an express licence with no more restrictive effect than an implied licence, is very wide. It includes the following types of transactions:<sup>81</sup>

- The application of cash balances and moneys received from trade for business purposes other than for the satisfaction of the charge debt.
- The payment of debts, even when made under threat of legal action, and the discharge of other liabilities.

<sup>77</sup> Gough *Company Charges* at 180.

<sup>78</sup> *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 540–541.

<sup>79</sup> *Company Charges* at 188; *Morse et al Charlesworth* at 507. For instance, a company is allowed to sell all or any of its assets in return for shares and debentures in another company as long as the company remains a going concern. See *Re Borax Co, Foster v Borax Co* [1901] 1 Ch 326. A company with three businesses is allowed to sell one of the three. See *Re HH Vivian & Co Ltd* [1900] 2 Ch 654.

<sup>80</sup> On the interpretation of ‘ordinary course of business’, see *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 540–541; *Re Hamilton’s Windsor Ironworks, ex parte Pitman and Edwards* (1879) 12 Ch D 707 at 713–714; *Wheatley v Silkstone and Haigh Moor Coal Co* (1885) 29 Ch D 715 at 724. On ‘as they think fit’, see *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 541; *Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) 15 Ch D 465 at 469.

<sup>81</sup> Gough *Company Charges* at 195.

- Mutual transactions that confer the right of set-off.
- The sale, disposition or exchange of assets.
- Leasing of assets or the disposal of assets on hire-purchase terms.
- The sale and lease back of assets.<sup>82</sup>
- The granting of other forms of security over the assets, including fixed mortgages or charges, contractual liens and pledges.<sup>83</sup>
- Transactions creating contractual rights over the charged assets, for example, contractual rights to take possession.
- The sale of the whole or a substantial part of the undertaking with a view to carrying on the same or a different business, which falls within the capacity of the chargor.<sup>84</sup>

It is therefore clear that even unprecedented or extraordinary transactions, such as the sale of the undertaking, would be allowed if they were effected for the purpose of maintaining the business as a going concern.<sup>85</sup>

Transactions that are viewed as falling outside the scope of the business-dealing licence include the following:<sup>86</sup>

- The sale of the whole or a substantial part of the undertaking with a view to terminating the company's business.<sup>87</sup>

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<sup>82</sup> There is no English law precedent for this view, but there is support for this position in Australian law. See *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1984) 8 ACLR 422 (SC NSW-CA). In this particular case the Court held that the transaction was in the ordinary course of business because the sale and lease back was not granted with the aim of ending its business, but as a last minute attempt by the dealer to extend its business life. The finding of the Court was reliant on the particular circumstances of that case and the decision may be distinguishable from other cases on that basis.

<sup>83</sup> Initial scepticism expressed about this view in *Re Panama, New Zealand, and Australian Royal Mail Co* (1870) 5 Ch App 318 at 322 was dismissed in all the subsequent cases. See for instance *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 541; *Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) 15 Ch D 465 at 472; *Wheatley v Silkstone and Haigh Moor Coal Co* (1885) 29 Ch D 715 at 719. It is now settled law that a floating charge cannot gain priority over subsequent fixed charges as this will be inconsistent with the intention of the floating charge, namely that the chargor will be free to deal with its assets in the continuation of its business.

<sup>84</sup> *Re Borax Co, Foster v Borax Co* [1901] 1 Ch 326 (the sale of all the assets of the company to another in exchange for shares and debentures in the other company is valid, because the company did not cease to trade); *Re HH Vivian & Co Ltd* [1900] 2 Ch 654 (the sale of all the assets held at a specific branch of the company); *Hubbuck v Helms* (1887) 56 LJ Ch 536 (the sale of all the assets of the company with a view to change the nature or the location of the business). On the capacity of a company, see n 88.

<sup>85</sup> *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1984) 8 ACLR 422 (SC NSW – CA) at 424, 428.

<sup>86</sup> *Gough Company Charges* at 196.

- *Ultra vires* transactions.<sup>88</sup>
- Fraudulent transactions.<sup>89</sup>

*Ultra vires* transactions and fraudulent transactions will not lead to the crystallisation of the floating charge, unless the business ceased to be a going concern. The remedy available to the chargee in these circumstances is an injunction to restrain the *ultra vires* transaction on the grounds of jeopardy to the security.<sup>90</sup>

In *Evans v Rival Granite Quarries Ltd*<sup>91</sup> the Court held that a business-dealing licence would only come to an end after an act of crystallisation has taken place, resulting in the chargee's right to intervene, coupled with an act of intervention by the chargee. The mere right to intervene alone will not suffice to vest a fixed charge in the property in priority over the other creditors.<sup>92</sup> Citing *Robson v Smith*,<sup>93</sup> the Court held

<sup>87</sup> *Hubbuck v Helms* (1887) 56 LJ Ch 536. In recent times this question has only arisen in Australian courts. The following Australian decisions will provide guidance to English law: *Hamilton v Hunter* (1983) 2 ACLR 295 (SC NSW); *Torzillu Pty Ltd v Brynac Pty Ltd* (1983) 8 ACLR 52 (SC NSW); *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 (SC NSW-CA). The intention or result that the going concern will cease, is paramount to this being a transaction outside the scope of the business-dealing licence. The cessation of the going concern will lead to the crystallisation of the floating charge. Legal purchasers without notice of the crystallisation circumstances will take priority over the crystallised charge. See Gough *Company Charges* at 208 and 211–214.

<sup>88</sup> The objects clause in the memorandum of association of the company determines the scope of its powers (capacity). A transaction that falls outside these objects and ancillary objects is outside the ordinary scope of business of a company. However, s 3A of the Companies Act 1985 provides that a company may state as its object "to carry on business as a general commercial company", which grants it almost limitless capacity as a legal person. Furthermore, s 35 of the Companies Act 1985 provides that no act of the company shall be invalid by reason of a lack of capacity as stated in the company's memorandum and s 35B states that a party to a transaction is not bound to enquire whether it is allowed by the memorandum of the company. As a result, very few transactions will fall outside the capacity of an English company and if so, the transaction will usually not be void. Under the Companies Act 2006 the objects of a company will be unrestricted, unless specifically restricted in its articles of association (ss 28 and 31(1), which becomes operational on 1 October 2008). When the objects of a company are restricted, third parties dealing with the company in good faith may assume that the company's directors are able to deal on the company's behalf free of restrictions (s 40). On the position under the Companies Act 2006 see Derek French, Stephen W Mayson & Christopher L Ryan *Mayson, French & Ryan on Company Law* (2007) at 97–104; Davis, Paul L; Worthington, Sarah & Micheler, Eva *Gower and Davies' Principles of Modern Company Law* 8 ed (2008) at 152–165.

<sup>89</sup> The only precedent directly in point is the New Zealand decision *Julius Harper Ltd v FW Hagedorn & Sons Ltd* [1991] 1 NZLR 530 (CA) where the company transferred goods to a related company with the aim to defraud creditors. This was held not to fall within the scope of the express business-dealing licence provided in this case. The position under an implied licence will be similar.

<sup>90</sup> *Re Borax Co, Foster v Borax Co* [1901] 1 Ch 326 at 341–342.

<sup>91</sup> *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

<sup>92</sup> *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 at 1002.

<sup>93</sup> *Robson v Smith* [1895] 2 Ch 118.

that under such circumstances the debenture-holder would not be allowed to prevent payment to a judgment creditor of the company.<sup>94</sup>

It will not be possible for the chargee to intervene when specific assets under the charge come under threat of being sold in execution or sold in the ordinary course of business. It is only possible for the chargee to crystallise the charge over a specific class of assets, for instance, all the book debts, but not over a specific asset.<sup>95</sup>

After the initial spate of cases in which a business-dealing licence was interpreted as an implied term of the floating charge agreement, draftsmen started to include express business-dealing licences in their floating charge agreements. An express licence given in a charge agreement may be narrower than the implied licence given to floating charges by the courts. This will depend largely on the wording of the licence clause.<sup>96</sup> These clauses should be interpreted in the same way, and given the same consequences, as restrictive clauses in contracts generally. It is quite common for an express clause to limit its period of operation until the occurrence of a specified act or event of default.

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<sup>94</sup> Lord Fletcher Moulton criticises the use of the word ‘licence’ in this context (at 997). Lord Buckley also rejects the contention of an implied licence to deal with the goods (at 999). Pennington 1960 *MLR* 630 at 645–646 explains why it is important to determine whether it is appropriate to use the term ‘licence’. First, if there is an implied licence, it must have limits. If there is a licence and the company wants to act in an *ultra vires* manner or dispose of the assets contrary to the security agreement, the debenture-holders will have the right to intervene, restricting the company’s right to deal. If there is no such licence, the debenture-holders will only have the right to intervene when a receiver is appointed. Second, if there is an implied licence, the licence will terminate on the winding-up of the company, even if it is due to amalgamation or restructuring, and a receiver will be appointed by the court. On the other hand, if there is no such licence the parties are free to regulate by agreement the circumstances under which a receiver will be appointed. Finally, if there is an implied licence, dispositions of assets made to judgment creditors will fall outside the ordinary scope of the business of the company and will be deferred to the claims of the debenture-holders. If there is no such licence, judgment creditors paid before the floating charge has crystallised will have priority, because at the date of the execution the debenture-holders could not interfere. It seems then that there is not truly a ‘licence’ to deal with the property while the charge is floating. Gough *Company Charges* at 180 argues that the term ‘licence’ should not be taken literally, but that the courts have described the power of the company to deal with its goods by different names including licence, freedom, power, liberty, right, authority, permission and mandate.

<sup>95</sup> Crystallisation over a particular class of assets will also have to be provided for expressly in the charge agreement, otherwise it will only be possible to crystallise the charge over all of the charged assets. See Goode *Legal Problems* at 143; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 at 1000; *Robson v Smith* [1895] 2 Ch 118 at 126. *Re Griffen Hotel Co Ltd, Joshua Tetley and Son Ltd v Griffen Hotel Co Ltd* [1941] Ch 129 provides an example of where crystallisation only occurred over a particular class of assets. The outcome of the case would be different today, since the coming into operation of s 175(1) and (2) of the Insolvency Act 1986 which state that preferential creditors will be paid in priority to the floating charge holder if the charge was created as a floating charge. See also Gough *Company Charges* at 171 and 1009–1010.

<sup>96</sup> Gough *Company Charges* at 194.

### 3.2.2.3 Crystallisation terms

In the absence of a crystallisation clause in the security agreement, crystallisation will occur by reason of winding-up, cessation of business and enforcement of the charge (receivership). This is seen as an implied term of a floating charge agreement.<sup>97</sup>

### 3.2.3 Crystallisation

As was stated above,<sup>98</sup> crystallisation is the process of converting the security from being floating in character to being specific or fixed.<sup>99</sup> A floating charge crystallises in the following circumstances:

- Where the company is wound up or otherwise ceases to do business. Under these circumstances the reason why the parties intend the charge to float, namely to circumvent paralysis of the company, becomes irrelevant.<sup>100</sup> The following three situations fall in this category:
  - 1 *Winding-up*:<sup>101</sup> This includes winding-up due to amalgamation or reconstruction.<sup>102</sup>
  - 2 *Cessation of trading without being wound up*.<sup>103</sup>
  - 3 *When the company disposes of its whole undertaking with a view to ceasing to be a going concern*.<sup>104</sup>

<sup>97</sup> Gough *Company Charges* at 172–178; *Re Brightlife Ltd* [1987] Ch 200 at 212–213. See also *National Westminster Bank plc v Jones* [2002] 1 BCLC 55 (CA) at 62H–63C.

<sup>98</sup> See n 19.

<sup>99</sup> Gough *Company Charges* at 135; *Goulding Principles* at 267; *Grier Company Law* at 458; *Davies Gower and Davies' Principles* at 823.

<sup>100</sup> Gough *Company Charges* at 139; *Re Panama, New Zealand, and Australian Royal Mail Co* (1870) 5 Ch App 318; *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530; *Re General South American Company* (1876) 2 Ch D 337.

<sup>101</sup> Gough *Company Charges* at 139–143.

<sup>102</sup> See *Re Crompton & Co Ltd, Player v Crompton & Co Ltd* [1914] 1 Ch 954. In this decision amalgamation and reconstruction of the company were expressly excluded in the charge agreement as events that would lead to the crystallisation of the floating charge. However, the Court refused to enforce these clauses (at 964–965), because the business-dealing licence was given to the old company and not to the newly formed company. Therefore winding-up for reconstruction would lead to the immediate crystallisation of the floating charge. There will be no new business-dealing licence for the new company, unless this is specifically provided for in a new agreement between the chargee and the new company.

<sup>103</sup> Gough *Company Charges* at 136; 143–144; *Davey & Co v Williamson & Sons Ltd* [1898] 2 QB 194; *In re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 376–378; *William Gaskell Group Ltd v Highley (Nos 1, 2, 3)* [1994] 1 BCLC 197 (Ch) at 206; *National Westminster Bank plc v Jones* [2001] 1 BCLC 98 (Ch) at 134E; *National Westminster Bank plc v Jones* [2002] 1 BCLC 55 (CA) at 62H–63C.

- Where the chargee enforces the floating charge.<sup>105</sup> The following situations fall in this category:
  - When the chargee takes possession of the charged assets through seizure under power or licence.<sup>106</sup>
  - Appointment of a receiver by, or on behalf of, the chargee.<sup>107</sup>
  - When the chargee obtains or utilises some other remedy for the enforcement of the security or for the protection of the charged assets.<sup>108</sup>

<sup>104</sup> *In re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 376. According to Gough *Company Charges* at 147–148, *Hubbuck v Helms* (1887) 56 LJ Ch 536 gave express authority for the view that business cessation leads to crystallisation (although the term ‘crystallisation’ did not yet exist at that time). So did *Robson v Smith* [1895] 2 Ch 118, although on the facts of that specific case it was found that the business had not ceased. See *Hamilton v Hunter* (1983) 7 ACLR 295 (SC NSW); *Torzillu Pty Ltd v Brynac Pty Ltd* (1983) 8 ACLR 52 (SC NSW); *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 (SC NSW – CA). These last-mentioned cases relate to the sale of the whole or substantially the whole of the business undertaking, which has in recent times only been considered in Australia. Gough *Company Charges* at 159 raises an interesting point when he asks whether the inquiry as to whether the business has ceased to be a going concern should be based on the intention of the company when selling these assets or whether the sale itself should constitute a presumption that the business will cease to be a going concern. The latter approach deals with an objective inquiry – if certain aspects regarding the sale are present the court will find that the company has ceased to be a going concern and therefore the floating charge will crystallise. The former approach deals with a subjective inquiry into the minds of the people behind the company veil, namely whether they intend to continue the business as a going concern or whether they are entering into an informal liquidation of the company’s assets. It seems that Gough prefers the subjective approach, namely that if the intention to cease the business is present the extent of the assets sold becomes irrelevant – the charge will crystallise. Even if substantially the whole of the undertaking is sold, but the intention to cease the going concern is absent, the charge may not crystallise. However, an extraordinary transaction may lead to the conclusion that the necessary intention was present.

<sup>105</sup> According to Goode *Legal Problems* at 140, the chargee’s intervention must comply with three criteria before it will crystallise the charge: (1) It must be done with the intention of converting the floating charge into a fixed charge. (2) It must be authorised by the express or implied terms of the floating charge agreement. (3) It must divest the company of its *de jure* control of the asset.

<sup>106</sup> *Re Hamilton’s Windsor Ironworks, ex parte Pitman and Edwards* (1879) 12 Ch D 707 at 710; *Re General South American Company* (1876) 2 Ch D 337 at 342; *Biggerstaff v Rowatt’s Wharf Ltd* [1896] 2 Ch 93 at 105–106; *Re Christonette International Ltd* [1982] 3 All ER 225 (Ch) at 230.

<sup>107</sup> *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 541; *Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) 15 Ch D 465 at 472. The appointment of a receiver does not necessarily mean that the company has ceased to carry on business. See Goulding *Principles* at 267; *In re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 376.

<sup>108</sup> *In re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 376. Obtaining an injunction will resort under this heading, but an injunction relating to a particular part of the assets will fix the charge only over those assets and the charge will remain floating over the rest. This is similar to the situation where a receiver is appointed for only a specific class of charged assets. The security then becomes fixed with regard to that particular group of assets, but not with regard to the rest. For example, the company has several clearly distinguishable enterprises that all fall under the floating charge, but the receiver is only appointed over one of them. This may be done, because there is no uncertainty over which part of the assets of the company the free dealing by the management of the company has been suspended; Gough *Company Charges* at 171. A chargee may not, however, try to crystallise the charge on a specific asset of the chargor. If such crystallisation were allowed, it would lead to uncertainty about the extent of the remaining floating charge. Furthermore, such

- Where crystallisation arises due to an express contractual term.<sup>109</sup>
- When the chargee notifies the chargor that in accordance with their agreement the charge shall crystallise with regard to the assets listed in the notice.<sup>110</sup>
- The occurrence of an event described in the charge as an event that shall lead to crystallisation.<sup>111</sup>

Unless stated otherwise in the charge agreement, the following events will not lead to crystallisation:<sup>112</sup>

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crystallisation is contradictory to the character of a floating charge, namely that the company remains free to deal with its property in the ordinary course of business. Crystallisation leads to the encumbrance of all the assets under the floating charge and the total suspension of the business-dealing licence; Gough *Company Charges* at 137.

<sup>109</sup> Automatic crystallisation following the occurrence of events specified in the charge agreement has been accepted by both Australian and New Zealand courts. Gough *Company Charges* at 233 prefers to call this form of crystallisation ‘express contractual crystallisation’. In *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 (SC NSW – CA) Chief Justice Gleeson approved the use of the automatic crystallisation clause used in the agreement. The security agreement provided certain circumstances that would be considered not to be in the ordinary course of business and would give rise to crystallisation. This crystallisation would then work retrospectively to before the transaction took place. This retroactive crystallisation of the charge was also approved by Chief Justice Gleeson (at 373). Judge Sheller, with whom Judge Handley concurred, also approved automatic crystallisation, but rejected the possibility of the retrospective crystallisation of the floating charge (at 379). In my opinion, the decision of Judge Sheller is preferable: the assets belonging to the chargor prior to the crystallisation and disposed of before the crystallisation of the charge may not retrospectively be considered to fall under the fixed charge. This is so because the business-dealing licence is incidental to a floating charge, which means that before crystallisation the chargor must be free to deal with its assets in the ordinary scope of business. See also *Stein v Saywell* (1969) 121 CLR 529 (HC of Australia); *Re Manurewa Transport Ltd* [1971] NZLR 909; *Re Permanent House (Holdings) Ltd* [1988] BCLC 563 (Ch) at 567; Goulding *Principles* at 268–269. Although automatic crystallisation has not been approved by the English courts, *In re Brightlife Ltd* [1987] Ch 200 at 215E–F approved *Re Manurewa Transport Ltd* [1971] NZLR 909 at 917: “a floating charge is not a word of art, it is a description for a type of security contained in a document which may provide a variety of circumstances whereupon crystallisation takes place.” It must be noted that this approval formed part of an *obiter dictum*. The danger with automatic crystallisation clauses is that third parties will have no notice of the fact that the floating charge is about to change in character to a fixed charge; see AJ Boyle “The Validity of Automatic Crystallisation Clauses” (1979) *J of Business Law* 231 at 236–237; Lightman *et al Administrators* at 84–90. Goode *Legal Problems* at 145–148, who in principle supports automatic crystallisation, draws the valid distinction between the validity of such clauses *inter se* and their validity when it comes to priority to third parties. The parties are free to regulate between them when the charge will crystallise, but the law will determine the priority of the crystallised charge against third parties. The Companies Act 1989 c 40 Part IV proposed a system whereby the events that would lead to automatic crystallisation would have to be registered with the charge. However, this part of the Companies Act was never brought into force; see Grier *Company Law* at 459. For a detailed discussion of automatic or express contractual crystallisation, see Gough *Company Charges* at 232–268.

<sup>110</sup> *Re Brightlife Ltd* [1987] Ch 200.

<sup>111</sup> *Stein v Saywell* (1969) 121 CLR 529 (HC of Australia); *Re Manurewa Transport Ltd* [1971] NZLR 909; *Re Brightlife Ltd* [1987] Ch 200; *Re Permanent Houses (Holdings) Ltd* [1988] BCLC 563 (Ch); *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 (SC NSW – CA). See also the discussion in n 109.

- The presentation of a winding-up petition.<sup>113</sup>
- The appointment of a provisional liquidator. The reason for this is that the provisional liquidator must seek the preservation of the *status quo* and the express continuation of the company's business at least to a limited extent. Since the going concern does not cease entirely, the floating charge does not crystallise.<sup>114</sup>
- The appointment of an administrator for purposes of an administration order. There is no direct authority for this view, but Gough<sup>115</sup> argues convincingly that due to the objectives of company survival and reconstruction contained in the Insolvency Act,<sup>116</sup> coupled with the extensive powers available to the administrator in terms of the Insolvency Act,<sup>117</sup> the charge will not crystallise automatically.
- The enforcement of a security held by another creditor.<sup>118</sup>
- The mere commencement of a debenture-holder's action seeking the appointment of a receiver.<sup>119</sup>

After crystallisation the intention is no longer that the chargor may deal with the property as he pleases and any property coming into the hands of the chargor will immediately and irrevocably be appropriated to the chargee.<sup>120</sup>

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<sup>112</sup> Gough *Company Charges* at 137–139.

<sup>113</sup> *Re Victoria Steamboats Ltd, Smith v Wilkinson* [1897] 1 Ch 158 at 161; *Stein v Saywell* (1969) 121 CLR 529 (HC of Australia) at 552, 556 and 561.

<sup>114</sup> The only authority for this view is the Australian decision *Re Obie Pty Ltd (No 2)* (1984) 8 ACLR 574 (SC of Queensland) at 581.

<sup>115</sup> *Company Charges* at 138 fn 3. See also Goode *Legal Problems* at 139.

<sup>116</sup> Insolvency Act 1986, s 8. These objectives are reiterated by the Enterprises Act 2002 c 40. See Department of Trade and Industry *Explanatory Notes: Enterprise Act 2002*, available at <http://www.opsi.gov.uk/acts/en2002/02en40-k.htm> (accessed 20 October 2005).

<sup>117</sup> Insolvency Act 1986, s 14 and Sch 1. These powers include the power to carry on the business of the company.

<sup>118</sup> *In Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 at 375 the Court held that the crystallisation of a second floating charge did not necessarily lead to the crystallisation of the first floating charge, unless the agreement expressly made provision for this. In the Court's opinion (at 379–380), the fixed nature of the second charge did not lead to a conclusion that the business of the company ceased, even though its business now mainly entailed selling its current stock-in-trade.

<sup>119</sup> *Re Hubbard & Co Ltd, Hubbard v Hubbard & Co Ltd* (1898) 68 LJ Ch 54.

<sup>120</sup> Gough *Company Charges* at 100. The charge will take the form of a fixed charge on crystallisation if the security agreement did not grant the chargee the right to foreclose or to take possession of the assets after crystallisation. The rights to foreclose and to take possession of the assets are not incidental to charges, but rather to mortgage. See Gough *Company Charges* at 101.



Unless the charge agreement expressly provides otherwise, the chargee will not be able to crystallise the charge over only a part of the assets, while leaving it floating over the rest. The security must be asserted over all the assets.<sup>121</sup>

### 3.2.4 Receivership

The chargee may intervene and prevent the company from continuing with its business through the appointment of a receiver.<sup>122</sup> A receiver appointed under a floating charge over all (or substantially all) the assets of the company is called an ‘administrative receiver’.<sup>123</sup> The power to appoint an administrative receiver was previously seen as one of the greatest advantages of the floating charge.<sup>124</sup> This position has now changed. The Enterprise Act 2002<sup>125</sup> introduced section 72A into the Insolvency Act 1986. Section 72A prohibits the appointment of an administrative receiver by the holder of a floating charge, except if the debt falls under one of the exceptions.<sup>126</sup> However, the exceptions only affect very large issues of debt<sup>127</sup> and

<sup>121</sup> Goode *Legal Problems* at 143; Lightman *et al Administrators* at 81–82; Davies *Gower and Davies’ Principles* at 824; Davies *et al Modern Company Law* at 1196 *et seq.*

<sup>122</sup> *Re Florence Land and Public Works Co, ex parte Moor* (1878) 10 Ch D 530 at 541; *Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) 15 Ch D 465 at 472; *Hubbuck v Helms* (1887) 56 LJ Ch 536 at 537–538; *Robson v Smith* [1895] 2 Ch 118 at 124, among others. On receivers generally, see Lightman *et al Administrators* at 4–7; Davies *Gower and Davies’ Principles* at 842–848; Davies *et al Modern Company Law* at 1199–1207.

<sup>123</sup> Insolvency Act 1986, s 29 (2). The receiver must be an insolvency practitioner.

<sup>124</sup> See Goode *Legal Problems* at 1–2; Lightman & Moss *Receivers* at 31 comment: “A fixed charge will have advantages for the chargee over a floating charge in terms of priorities but the floating charge may give greater flexibility to the debenture-holder in terms of remedies and enforcement.” In view of the recent amendments, discussed below, these advantages have now been removed. See Lightman *et al Administrators* at 8–9. See also par 3.2.5.

<sup>125</sup> c 40.

<sup>126</sup> These provisions apply to all floating charges created on or after the date that the amendments came into force. Charges created before this date will therefore retain the power to appoint an administrative receiver. The Enterprise Act 2002 in s 248 and sch 16 as reflected in sch B1 of the Insolvency Act 1986 attempts to encourage floating charge holders to go the administration route by making it easier for them to apply for administration. Pars 14–21 of the schedule allows floating charge holders to appoint an administrator out-of-court when the charge is enforceable, notice has been given to any floating charge holders who may have priority over their charge, the company is not in liquidation and neither an administrative receiver nor an administrator is already in office. Notice must be given to the floating charge holders when the company or the board of directors appoint an administrator and the floating charge holders then have the right to appoint their own administrator instead (par 14). However, the appointment of an administrator does not hold the same benefits for the floating charge holder as the appointment of an administrative receiver. The latter owes his duties primarily to his appointor rather than to the general body of creditors and his primary function is to recover the debt owed to the appointor (see DTI *Explanatory Notes* par 642). An administrator is an officer of the court and an agent of the company (DTI *Explanatory Notes* par 646) and as such will not seek to protect the interests of the appointor foremost.

certain debts typically incurred in the public interest.<sup>128</sup> It follows that this power has been removed for most future floating charges and therefore the rest of this paragraph only relates to receivers appointed by the chargee over a part of the assets of the company<sup>129</sup> and to receivers appointed under floating charges created before commencement of the Enterprises Act.

The receiver is usually appointed out of court.<sup>130</sup> It is a condition of crystallisation that the receiver must have accepted his appointment.<sup>131</sup> Legal commentators are divided on the question of whether possession of the assets, or at least an attempt by the receiver to gain such possession, is a prerequisite for crystallising the charge. Gough<sup>132</sup> makes out a good case for the proposition that possession, or an attempt to take possession, may be necessary, since the old authorities emphasised the need for the chargee to intervene actively before crystallisation may occur. A requirement of possession by the receiver will lead to more certainty as to which assets fall under the now fixed charge and which could still be dealt with under the business-dealing licence under the floating charge. Possession will protect the chargee against possible defences based on estoppel and will provide third parties with notice of the changed

<sup>127</sup> A receiver may still be appointed where the company issues secured debentures and where the security is held by a trustee on behalf of debenture-holders, the issue is for £50 million or larger, and the debentures are to be listed or traded on a regulated market. Many securitisation transactions will be large enough to fall under this exception. See Insolvency Act 1986, ss 72B; 72E; 72F. See also Davies *Gower and Davies' Principles* at 841; Davies *et al Modern Company Law* at 1198.

<sup>128</sup> Insolvency Act 1986, s 72C (public-private partnerships); 72D (utilities); 72DA (urban regeneration projects); 72G (registered social landlord) and s 72GA (companies appointed under the Water Industry Act 1991, protected railway companies in terms of the Railways Act 1993 and licenced companies under the Transport Act 2000).

<sup>129</sup> The entitlement to crystallise the floating charge over a part of the assets will have to be expressly included in the charge agreement, since partial crystallisation is otherwise not possible. See par 3.2.3 above.

<sup>130</sup> The receiver may be appointed by court order, but this is more costly and takes longer. See Goode *Legal Problems* at 141.

<sup>131</sup> Insolvency Act 1986, s 33 states that the appointment of a receiver is only effective after it has been accepted by the appointed person. See also *Re Gabriel Controls Pty Ltd (Receiver and Manager Appointed)* 6 ACLR 684 SC (SA) where the Court held that crystallisation was postponed until the appointed receiver accepted his appointment.

<sup>132</sup> *Company Charges* at 166; Goode *Legal Problems* at 141 takes the opposite view. He cites cases where the cases of execution creditors on whose behalf the sheriff has levied execution on goods subject to a floating charge are postponed if a receiver is appointed before the goods are sold (*Re Standard Manufacturing Co* [1891] 1 Ch 627(CA); *Re Opera Ltd* [1891] 3 Ch 260). Obviously a receiver could not take possession of those goods in order to vest appointment. According to him, the receiver's appointment is immediately effective because the company, when it agreed to it in the charge agreement, has accepted that it will lose its powers of management on the appointment of the receiver.

nature of the charge. In practice, however, the receiver will attempt to take possession of the tangible assets and will give notice to trade debtors of his appointment.<sup>133</sup>

### 3.2.5 Advantages of floating charges

The main advantage from the company's point of view is that it can provide security for a loan by charging assets that are revolving in nature and over which it would have been impracticable to give a fixed charge. Increasingly, the only assets that a company has available to offer as security, namely stock-in-trade, book debts and licences over various intellectual property rights, fall into this category. Furthermore, the company can carry on its business in the ordinary way until the charge has been crystallised.<sup>134</sup> However, this advantage is off-set by the weak priority that the floating charge provides against other creditors of the company.<sup>135</sup>

One other advantage of the floating charge has now almost been abolished.<sup>136</sup> Only a floating chargee had the power to appoint an administrative receiver to manage the entire business of the company.<sup>137</sup> However, administrative receivership was believed to hamper the prospects of reorganisation.<sup>138</sup> Section 9(3) of the Insolvency Act 1986 required a court to dismiss an application for an administration order where there was an administrative receiver, unless the administrator consented. This led to banks insisting on receiving a floating charge over and above any fixed charges, even where the amount secured was negligible.<sup>139</sup>

<sup>133</sup> Gough *Company Charges* at 166–167. The Insolvency Act 1986, s 46(1) requires notice of the appointment to be sent to the company and, within 28 days after the appointment, to all the creditors of the company. Furthermore, every official document of the company must contain a statement that a receiver has been appointed (s 39).

<sup>134</sup> Morse *et al Charlesworth* at 507. Grier *Company Law* at 457–458 describes the virtue of the floating charge as striking a balance between the lender's need for security and the company's need to continue trade with the charged assets.

<sup>135</sup> See par 3.2.6 below for the priority rules of floating charges.

<sup>136</sup> See n 126.

<sup>137</sup> Insolvency Act 1986, s 29(2).

<sup>138</sup> Insolvency Act 1986, s 72A(1) inserted by the Enterprise Act 2002, s 250(1). See also the discussion in par 3.2.4 above.

<sup>139</sup> Richard Smerdon *Palmer's Company Law Manual* (2000) at 295. An administration order would necessitate an application by a fixed chargee to court before he may enforce his security (Insolvency Act 1986, s 11). The possibility of barring an administration order therefore strengthens the position of the fixed chargee. Goode *Legal Problems* at 119 argues that repealing s 9(3) would have been a more elegant way of removing this problem, rather than more or less abolishing administrative receivership.

The floating charge agreement can be shaped largely according to the will of the parties. This makes the floating charge a very flexible form of security.

### 3.2.6 Disadvantages of floating charges

The essential disadvantage of accepting a floating charge rather than a fixed charge is the weak priority it provides the chargee.<sup>140</sup> It ranks in priority after all other fixed charges on the asset, regardless of whether the fixed charge was created after the floating charge.<sup>141</sup> Execution creditors who had goods sold in execution by the sheriff will have preference to the floating chargee before crystallisation.<sup>142</sup> The floating chargee will have to wait until the landlord's lien and contractual liens have been settled. If a receiver is appointed, the preferential debts of the company must be paid before the floating charge.<sup>143</sup> If the chargee takes possession of the assets rather than to appoint a receiver, the preferential debts take priority over the floating charge.<sup>144</sup> Later floating charges will not have priority over, or rank *pari passu* with, a floating charge, regardless of whether the later charge agreements provided for it, where they are in respect of the same assets.<sup>145</sup>

Furthermore, the fact that the charge started off as a floating charge may lead to the ostensible authority of the company to deal with its assets in the ordinary course of business after crystallisation.<sup>146</sup> No official method of publicising the crystallisation of the charge exists. Such ostensible authority to deal with the assets may affect priorities in subsequent dealings, because a third party purchaser or a subsequent chargee that takes without notice of the crystallisation will obtain priority over the

<sup>140</sup> On the disadvantages of floating charges generally, see also Davies *Gower and Davies' Principles* at 821–823.

<sup>141</sup> *Lightman et al Administrators* at 78–79.

<sup>142</sup> *Re Opera Ltd* [1891] 3 Ch 260; *Robson v Smith* [1895] 2 Ch 118; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

<sup>143</sup> Insolvency Act 1986, s 40.

<sup>144</sup> Companies Act 1985, ss 196(1) and (2). Judicial opinion differs on whether the appointment of a receiver on behalf of one floating charge holder will automatically lead to all other floating charges being subordinated to the claims of the preferential creditors. In *Griffiths v Yorkshire Bank plc* [1994] 1 WLR 1427 (Ch) at 1433–1434 the Court held that crystallisation by other means than through possession or receivership will not lead to the priority of the preferential creditors, but in *Re H & K Medway Ltd* [1997] 1 WLR 1422 (Ch) the Court held that all the floating charges became subordinated to the claims of the preferential creditors. Goode *Legal Problems* at 196 agrees with the latter position.

<sup>145</sup> *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800.

<sup>146</sup> Goode *Legal Problems* at 118, 134–135; *Lightman et al Administrators* at 87–90.

floating chargee.<sup>147</sup> When the charge is in respect of book debts and has crystallised, purchasers or chargees that take without notice after crystallisation of the charge may still enjoy priority by virtue of the rule in *Dearle v Hall*.<sup>148</sup> This rule states that if a second or subsequent assignee has no notice of the prior assignment, he can gain priority by being the first to notify the debtor of the assignment.

When the company goes into insolvent liquidation, the costs of winding-up (e.g., liquidator's fees) and the preferential creditors must be paid before the floating charge holders, if the charge was created as a floating charge,<sup>149</sup> in other words, the costs of winding-up and the claims of the preferential creditors will have priority over the floating charge, even if it has crystallised before commencement of the winding-up. In the event of an agreement between a prior fixed chargee and a floating chargee that the latter will have priority above the former, both the fixed charge and the floating charge will rank after the costs of winding-up and the claims of the preferential creditors.<sup>150</sup>

<sup>147</sup> *English & Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700; Goode *Legal Problems* at 177, 181.

<sup>148</sup> *Dearle v Hall* (1828) 3 Russ 1. See also Goode *Legal Problems* at 182.

<sup>149</sup> Insolvency Act 1986, s 175(2)(b). In *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 718 the reason for this rule is explained, namely to prevent the company from having no assets left with which the liquidator can pay the preferential creditors. This is always a possibility in the case of a floating charge over the undertaking, because if the charge crystallises before winding-up all of the movable assets of the company will fall under the charge to the exclusion of the preferential creditors. See also Goode *Legal Problems* at 118. Note that the Crown's preference (meaning the preferential payment of claims for taxes against the insolvent estate) was abolished by ss 251 and 252 of the Enterprise Act 2002. Preferential debts now consist of contributions to occupational pension schemes (Insolvency Act 1986, sch 6 category 4), remuneration of employees for the relevant period (Insolvency Act 1986, sch 6 category 5) and levies on coal and steel production under the European Coal and Steel Community Treaty (Insolvency Act 1986, sch 6 category 6). However, the Crown's preference was abolished with the aim to benefit the unsecured creditors (DTI *Explanatory Notes* par 721). Section 252 inserted s 176A into the Insolvency Act 1986 to further this aim by allocating a percentage (to be prescribed) of the company's net assets under a floating charge to the unsecured creditors. The abolition of the Crown's preference should therefore not be seen as a benefit to the floating charge holders. In the light of s 176A it is rather another way to lessen the fund available to the floating charge holder and should be seen as a disadvantage. See also Davies *Gower and Davies' Principles* at 826–828.

<sup>150</sup> *Re Portbase Clothing Ltd* [1993] BCLC 796 (Ch) at 802D–E. In this decision the Court acknowledged the possibility of a trust construction whereby the fixed chargee holds the amount of the floating charge in trust for payment to the latter (at 811G–812D). However, this is then not linked to the floating charge itself and payment will be due by the fixed chargee even if the floating charge turns out to be invalid. It is therefore not a priority arrangement (or subordination agreement), but rather an independent undertaking by the fixed chargee to pay the floating chargee from the proceeds of realisation. If this is the intention of the parties, it has to be expressed clearly in the agreement in order to avoid the consequence of the fixed charge losing priority to the costs of winding-up and the claims of the preferential creditors.

The weak priority provided by the floating charge is most disadvantageous when coupled with the situation where the floating charge is the only viable option as security; as in the case of charges over book debts.<sup>151</sup> Assets associated most closely with the cash flow of the company, such as the book debts and the stock-in-trade, traditionally form the objects of floating charges. Providing fixed charges over such assets will lead to the economic paralysis of the company. This leaves only the floating charge and the weak priority it provides. The disadvantage is even greater if these assets form the majority of the assets available to offer as security.

Usually the charge agreement will contain a negative pledge clause that precludes the creation of a second charge with priority over the floating charge. The effectiveness of negative pledge clauses is open to doubt. Although they will certainly be binding on the contracting parties, their effect on third parties is less certain. Courts have upheld negative pledge clauses only if the third party had actual knowledge of them.<sup>152</sup> Registration only gives notice of the existence of a charge and not of its terms.<sup>153</sup>

Most charges must be registered with the Registrar of Companies within 21 days of the charge's creation.<sup>154</sup> All charges to secure an issue of debentures, charges on book debts, floating charges and charges on intellectual property must be registered.<sup>155</sup> On registration the Registrar issues a certificate that is conclusive evidence that the registration requirements have been complied with even if this is not the case.<sup>156</sup> Failure to register the charge in time will make the charge void against the liquidator,

<sup>151</sup> See par 3.2.1.1 above.

<sup>152</sup> *English & Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700 at 707. Also see Goode *Legal Problems* at 176–177; *Lightman et al Administrators* at 79–81.

<sup>153</sup> *Wilson v Kelland* [1910] 2 Ch 306; *Ian Chisholm Textiles Ltd v Griffiths* [1994] BCLC 537 (CA); *Goulding Principles* at 270, 276.

<sup>154</sup> Companies Act 1985, s 398, Companies Act 2006 s 870(1)(a). See also McCormack *Secured Credit* at 221–223; *Davies Gower and Davies' Principles* at 831–837. The aim of this requirement is to inform trade creditors of the existence of such charges. See *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at 718; *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL) at 347H. For the position under the Companies Act 2006 generally, see French *et al Company Law* at 311–317; *Davies et al Modern Company Law* at 1182–1187. The registration requirements have for the most part remained unchanged in the new Act. See also Andrew McKnight “A Review of Developments in English Law During 2006: Part 1” (2007) *J of Int Banking Law and Regulation* 127 at 132.

<sup>155</sup> Section 396 of the Companies Act 1985 (s 860 of the Companies Act 2006) provides the full list of charges that must be registered.

<sup>156</sup> Companies Act 1985, s 401(2), Companies Act 2006, ss 869(5) and (6); *Re CL Nye Ltd* [1971] Ch 442 (CA); *Morse et al Charlesworth* at 524; *Lightman et al Administrators* at 113.

an administrator or any other creditor.<sup>157</sup> This means that if the registration requirement is not met, the lender will be an unsecured creditor of the company. If a registrable charge is not registered in time, the loan is immediately repayable.<sup>158</sup>

While the registration requirement seems simple enough, compliance is often not achieved.<sup>159</sup> The only way to rectify such a situation is by order of court. If the company's liquidation is imminent or has already occurred, the court is unlikely to grant the order unless special circumstances are present.<sup>160</sup> Even if the late registration is granted, it will not prejudice the rights of creditors who registered charges against the company's property before registration of the charge.<sup>161</sup> Such secured creditors will retain their priority, even if their agreements were entered into after the initial charge had been negotiated.

Lastly, some authors argue that the floating charge has become overly complicated.<sup>162</sup> This is partly due to its origins as a judge-made creation of law and partly due to legislative interventions to curb its applicability and scope. Despite this, several recommendations to adopt personal property security legislation similar to that found in the United States have gone unheeded.<sup>163</sup> It remains to be seen if the latest recommendations to this effect will lead to a different outcome.<sup>164</sup>

<sup>157</sup> Companies Act 1985, s 395, Companies Act 2006, s 874(1); Lightman *et al Administrators* at 109. See also *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL) where the classification by the Court of the charge as a floating charge meant that it was not registered according to this section and therefore void against the administrator. For a discussion of this case see Karen Yeung "The Cosslett Saga: Implications for the Law of Security over Personal Property" (2002) 20 *Company and Securities Law Journal* 177.

<sup>158</sup> Companies Act 1985, s 395(2), Companies Act 2006, s 874(3).

<sup>159</sup> *Morse et al Charlesworth & Morse* at 464 lays the blame for much of the non-compliance with the registration requirements at the door of an overburdened Registrar's office and with solicitors who procrastinate in the timeous fulfilment of their duties.

<sup>160</sup> Such as the fact that the non-registration was due to the solicitor's negligence and that the chargee acted promptly on the discovery of the non-registration; *In re Braemar Investments Ltd* [1989] 1 Ch 54; Lightman *et al Administrators* at 111–112.

<sup>161</sup> *Re Monolithic Building Co* [1915] 1 Ch 643 (CA).

<sup>162</sup> See Goode *Legal Problems* at 153.

<sup>163</sup> These recommendations relate to personal property security as a whole and not only to the future of the floating charge. The Crowther Committee on Consumer Credit was the first to make recommendations (*Report of the Committee on Consumer Credit* (Cmnd 4506, 1971). The Crowther Report recommended the uniform treatment of all security interests, including that the extension of credit in sale or hire purchase transactions be treated as a purchase-money loan, that reservation of ownership, hire purchase, conditional sale and financial lease be treated as chattel mortgage (mortgage of movables) and that the outright sale of book debts under a factoring agreement be treated as a charge over the book debts. In the end the consumer credit provisions of the Report were accepted, but not the proposals for the restructuring of security. The Insolvency Law Review Committee *Insolvency Law and Practice* (Cmnd 8558, 1982) and AL Diamond *A Review of Security*

### 3.3 SECURITISATION: SPECIFIC CONSIDERATIONS

The general form and functioning of a securitisation scheme is discussed in Chapter 2. The form of securitisation schemes in South Africa is largely based on those found in England and the United States of America. I therefore do not repeat it here, but only focus on legal aspects that differ from the law in South Africa.

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*Interests in Property* (1989) both supported the recommendations. The latter proposed ‘security interest’ as a term denoting two types of interests in property: (1) Where the owner or another person with some interests in property transfers full legal ownership or creates some lesser right in favour of the creditor to secure the debtor’s obligations, for instance mortgage, lien, charge, pledge. (2) Where rights in property are created or retained to secure the performance of the obligation, such as hire purchase, retention of title under a conditional sale agreement, retention of title clause or financial lease. None of these recommendations was implemented.

<sup>164</sup> The Company Law Review Steering Group *Modern Company Law for a Competitive Economy: Final Report* (2001) recommended that the notice-filing concept of revised Article 9 of the Uniform Commercial Code used in the United States be adopted in England. The Law Commission has since issued a consultation paper that elaborates on this recommendation (*Registration of Security Interests: Company Charges and Property other than Land* (Consultation Paper No 164, July 2002). The recommendation is that a financing statement be filed for registration, which contains brief details of the transaction or series of transactions that secure payment or performance of an obligation (at 61). The date of filing will largely determine the priorities between different holders of security (at 97–101). The nature of the charge as fixed or floating will not be registered, but automatic crystallisation will have to be registered to have effect (at 103). Both the Steering Group *Final Report* at par 12.59 and the Law Commission *Company Charges* at 132 state that charges are no longer in practice given to secure issues of debentures and that it is therefore unnecessary to make provision for its registration. The Law Commission states that if certain charges are not used very often, they see no reason why they should nonetheless make provision for them. See also Goode *Legal Problems* at 3–4. The Consultation Paper was followed by a Consultative Report, *Company Security Interests* (Consultative Report No 176, September 2004). This document was largely based on the Consultation Paper, with minor amendments to address certain criticism of the Consultation Paper. See Gerard McCormack “The Law Commission Consultative Report on Company Security Interests: An Irreverent Riposte” (2005) 68 *Modern Law Review* 286. The Final Report followed (Law Commission *Company Security Interests: Final Report* (Report No 296, August 2005), available at [www.lawcom.gov.uk](http://www.lawcom.gov.uk) (accessed 28 January 2008), which included draft regulations to the future Companies Bill. The Final Report did not go as far as the previous recommendations of the Law Commission. For instance, it retained the distinction between fixed and floating charges. For a detailed discussion of the recommendations of the Final Report, see Andrew McKnight “The Reform of English Law Concerning Secured Transactions: Part 2” (2006) 21 *J of Int Banking Law and Regulation* 587. I discuss the Final Report’s recommendations with specific importance for securitisation in the relevant paragraphs below. It would perhaps be more practical for England to wait for the European Union’s recommendations on a Unified Private Law before they commence to implement a system of personal property security that is very foreign to the system known on the continent. Notice-filing does not enjoy much support in Europe and even Scotland rejected proposals to adopt a notice-filing system. See McCormack 2005 *MLR* at 290–291, 307–308. See, however, the Law Commission’s *Final Report* at 30. It should further be mentioned that not all commentators share the view that a system similar to Article 9 is preferable. See for instance Gerard McCormack “Personal Property Security Law Reform in England and Canada” (2002) *Journal for Business Law* 113; McCormack 2005 *MLR* at 289–295. For an overview of the adoption of personal property security legislation in jurisdictions other than the United Kingdom, see Dugald McWilliams “The Floating Charge and its Place Within Article 9, PPSA Security Regimes and Australian Law” (2004) 22 *Company & Securities Law Journal* 481.



### 3.3.1 Regulatory considerations

Securitisation in England is not regulated by a single piece of legislation, but is structured according to the common law principles of an assignment of claims. However, the following aspects from legislation are important when structuring a securitisation scheme in England:

#### 3.3.1.1 Financial Services and Markets Act of 2000

The Financial Services and Markets Act of 2000<sup>165</sup> repealed the Financial Services Act of 1986.<sup>166</sup> It provides for the regulation of financial services and markets, which includes the regulation of securities exchanges and clearing houses, market abuse and collective investment schemes.

Compliance with the provisions of the Act is required if the securities issued by the SPV are to be listed on the London Stock Exchange.<sup>167</sup> The disclosure requirements generally aim to inform investors and their professional advisors about the risks and benefits of the potential investment.<sup>168</sup> The general duty of disclosure is tempered by having regard to the nature of the securities to be traded, the nature of the trader and the nature of the persons most likely to acquire the securities.<sup>169</sup> The fact that the issuer of the securities is an SPV with no business operations outside of the securitisation will therefore limit the necessary disclosure. Furthermore, the typical investors in these securities are professional and experienced, and have access to professional advisors and other resources.

It is possible that a securitisation scheme may be considered a collective investment scheme under the definition of the Financial Services and Markets Act of 2000.<sup>170</sup> Section 235 defines collective investment schemes as:

- (1) any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or

<sup>165</sup> c 8.

<sup>166</sup> c 60.

<sup>167</sup> Part VI of the Financial Services and Markets Act of 2000.

<sup>168</sup> Section 80.

<sup>169</sup> Section 80(4).

<sup>170</sup> See also Wood *Title Finance* at 65.

- income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.
- (2) The arrangements must be such that the persons who are to participate (“participants”) do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.
  - (3) The arrangements must also have either or both of the following characteristics—
    - (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
    - (b) the property is managed as a whole by or on behalf of the operator of the scheme.

Treasury may order that an arrangement does not amount to a collective investment scheme in specified circumstances or if the arrangement falls under a certain category of arrangement.<sup>171</sup> If the SPV cannot obtain an exemption from the provisions relating to collective investment schemes from Treasury, it will have to comply with Part XVII of the Financial Services and Markets Act of 2000, which regulates collective investment schemes.

Under the previous Act, an exemption was granted to schemes where the rights or interests of participants were represented by debt instruments issued by a single body corporate.<sup>172</sup> In the current Act, this exemption is retained and extended so that an issuer that is not a body corporate, but is guaranteed by the government, will qualify.<sup>173</sup> Many securitisation schemes could benefit from this exemption.

### 3.3.1.2 Companies Act 1985<sup>174</sup>

The Companies Act 1985 is relevant to a securitisation scheme if the SPV is a company.

Of specific importance is the duty expressed in section 258 that a parent company must prepare group accounts for itself and its “subsidiary undertakings”.<sup>175</sup> If it is important for the originator not to incorporate the transferred assets on its balance sheet, the originator must ensure that neither the issuer SPV, nor its parent company, is a subsidiary of either the originator or the originator’s parent company.

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<sup>171</sup> Section 235(5).

<sup>172</sup> Schedule 1 par 35(b)(i) of the Financial Services Act of 1986. See further Norton *et al Asset Securitisation* at 61.

<sup>173</sup> Schedule par 5(1)(a) of the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (Statutory Instruments 2001 No 1062).

<sup>174</sup> While writing this thesis the applicable provisions of the Companies Act 2006 had not as yet commenced. The provisions of the Companies Act 1985 are therefore discussed, with reference to the comparable provisions of the Companies Act 2006.

<sup>175</sup> Section 1162 of the Companies Act 2006. For the position under the Companies Act 2006 generally, see French *et al Company Law* at 255–257; Davies *et al Modern Company Law* at 718–721.

This can be achieved by ensuring that the originator does not hold or control a majority of the voting rights in the issuer SPV and does not control the board meetings of the SPV. The issuer SPV will further be considered a subsidiary undertaking of the originator if its articles of association contain a provision that the originator has the right to give directions with respect to the operating and financial policies of the issuer with which its directors are obliged to comply whether or not for the benefit of the issuer.<sup>176</sup> Under these circumstances the originator will be considered the parent company of the issuer SPV, even if the originator is not a shareholder of the SPV. It is further not necessary to show that the originator actually makes use of its right to control the SPV. The existence of the right suffices.<sup>177</sup>

If the originator holds shares in the SPV and is shown to have a dominant influence over the SPV or that the originator and the SPV are managed on a unified basis, the SPV will be considered a subsidiary undertaking of the originator. *De facto* control is the indicating factor here and not any rights to exercise control. However, this provision will only apply if the originator holds shares in the SPV and is therefore easily avoidable.<sup>178</sup>

### 3.3.2 Transfer of rights and ‘true sale’ requirement

The assets must be legally isolated from the estate of the originator by way of a true sale to the SPV. A true sale has the following characteristics:<sup>179</sup>

- The seller must not retain any liabilities in respect of the assets, except for typical warranties for defects. The seller must not guarantee the recoverability of the claim, have a duty to repurchase the claim or have a moral duty to compensate for any shortfalls. The seller must not carry any further risk associated with the asset after the transfer to the buyer. It must not retain a right to repurchase the transferred assets.
- The buyer acquires exclusive control and ownership over the asset. The buyer can sell the asset or give it as security and receives all profit gained from it. There is

<sup>176</sup> This is referred to as the ‘right to exercise a dominant influence’ in par 4 of Schedule 9 of the Companies Act 1989, which introduced these requirements for group accounts. See s 1162(2)(c) of the Companies Act 2006.

<sup>177</sup> Norton *et al* *Asset Securitization* at 56.

<sup>178</sup> Norton *et al* *Asset Securitization* at 57.

<sup>179</sup> Wood *Project Finance* at 156.

no obligation on the buyer to account to the seller for any extra amounts realised from the assets.

- The transfer of the assets must not be vulnerable to be set aside by the liquidator of the seller in the event of the latter's insolvency. I discuss this requirement separately in paragraph 3.3.3.

### 3.3.2.1 Equitable assignment

A transfer of claims in English law is made by way of assignment. Assignment is a transaction between a person entitled to the benefit of a contract, called the 'assignor', and a third party, called the 'assignee', as a result of which the third party becomes entitled to sue the person liable under the contract. The debtor is not a party to the transaction and his consent is not required.<sup>180</sup>

In English law claims are usually transferred to the SPV by means of an equitable assignment.<sup>181</sup> The SPV only acquires an equitable right to the claims, because no notice of the assignment is given to the debtors. A further reason why an equitable assignment may be the only option available for transfer of the claims to the SPV is that the legal assignment of a future claim is not allowed in English law.<sup>182</sup> A legal assignment requires notice of the assignment to debtors and there must be compliance with any further formal requirements, such as registration in the Land Registry in the case of mortgages. Registration presents a financial and administrative burden that can be avoided by an equitable assignment.<sup>183</sup>

<sup>180</sup> Edwin Peel *The Law of Contract* 12 ed (2007) at 714. 'Assignment' therefore has a different meaning in English law than in South African law, where the term refers to a transfer of rights and duties. See par 7.2.2.1. As is the case in South African law, English law does not recognise the transfer of a contractual liability without the consent of the creditor. See *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85 (HL) at 103; Peel *Contract* at 747.

<sup>181</sup> It is possible to transfer the assets by way of novation, but novation requires the consent of the debtors. Acquiring the consent of debtors is not cost effective and presents an administrative burden. See *Wood Title Finance* at 51; Norton *et al Asset Securitization* at 54. Legal assignment is regulated by s 136(1) of the Law of Property Act 1925 which sets the following requirements: (a) the assignment must be evidenced in writing by the assignor; and (b) express notice in writing must be given to the debtor. If these requirements are met, the assignee acquires from the date of notice to the debtor (a) the legal right to such a debt; (b) all legal rights and remedies in connection with the debt; and (c) the power to give a good discharge for the debt without the assignor's cooperation. On the requirements for legal assignment generally, see Peel *Contract* at 721–725.

<sup>182</sup> *Raffaelsen Zentralbank Österreich AG v Five Star General Trading LLC* [2001] 3 All ER 257 (CA) at 283D–E, 285B–D. See further Peel *Contract* at 726.

<sup>183</sup> See *Wood Project Finance* at 135; McCormack *Secured Credit* at 224.

The SPV is given a power of attorney to enforce the claims and to register the transferred assets when it becomes necessary.<sup>184</sup> If there is any physical paper to evidence rights in the transferred assets, the SPV usually takes custody and control of that paper.<sup>185</sup>

Notice to debtors is avoided because of its expense and inconvenience.<sup>186</sup> Furthermore, the originator usually wishes to maintain a relationship with the debtors and continues with collection of the claims. The originator will also have the systems in place and the data available to administer the collection of the claims effectively.

In English law effect is given to an equitable assignment on the insolvency of the seller,<sup>187</sup> in this case the originator, without notice to debtors provided that consideration has been given in return for the transfer and that the intention to assign is clear.<sup>188</sup> However, assignments without notice to debtors have certain implications:<sup>189</sup>

- The SPV may lose priority if the originator resells or charges the same claims to a third party. This is due to the application of the rule in *Dearle v Hall*.<sup>190</sup> The rule in *Dearle v Hall* states that when a second assignee has no notice of the previous assignment at the time of the second assignment, the second assignee can gain priority over the first assignee by being the first to give the debtors notice of the assignment.<sup>191</sup> Further assignments of, or charges over, the claims by the

<sup>184</sup> Wood *Project Finance* at 135.

<sup>185</sup> Wood *Title Finance* at 52; Norton *et al Asset Securitization* at 54.

<sup>186</sup> Wood *Project Finance* at 134. Please refer to the points set out below for the risks that the absence of notice to the debtors pose.

<sup>187</sup> However, the Law Commission in its *Final Report* at 31 and 110 (par 4.25) recommended that the registration of a sale of receivables should be required as a condition for the validity of the sale against an administrator or liquidator of the assignor. No further action has been taken after the release of these recommendations. ‘Receivables’ is defined narrowly by the Law Commission and only includes “monetary obligations arising from the supply of goods and services” (at par 4.27). It does not include sums payable under loan agreements, rent, mortgage repayments or insurance premiums. Many assets sold during a securitisation scheme will therefore fall outside the requirement for notice-filing in terms of the Law Commission’s recommendations. It was felt that securitisation in English law does not need the protection it needs in American law (par 4.26). See also the discussion of McKnight 2006 *JIBLR* at 591–592.

<sup>188</sup> *Ward v Duncombe* [1893] AC 369 at 392; McCormack *Secured Credit* at 224.

<sup>189</sup> Wood *Project Finance* at 134–135.

<sup>190</sup> (1828) 3 Russ 1.

<sup>191</sup> The rule is widely criticised as an unsatisfactory method of determining priorities during receivables financing. See for instance McCormack *Secured Credit* at 244. Fidelis Oditah *Legal Aspects of Receivables Financing* (1991) at 140–142 summarises his criticism of the rule into seven points: (1) The rule in *Dearle v Hall* is not rooted in any coherent principle and has led to injustice, especially

originator are prohibited by the transaction documentation. Investors and the rating agencies rely on compliance with the prohibition by the originator.

- The debtors continue to pay the originator if it acts as servicer, which could lead to the mingling of payments in the servicer's accounts. This risk is managed relatively easily by either directing payments directly to the SPV's account or by setting up an account where the originator/servicer may deposit payments, but does not have the power to withdraw any money without the SPV's consent. The account is then emptied after the close of day into the SPV's account.

The position becomes more complicated if the originator/assignor does not continue to collect the debts as servicer. During an equitable assignment a debtor that has not received notice of the assignment will get a good discharge for the debt when paying the original creditor, in other words, the originator.<sup>192</sup> This suggests that notice has to be given to debtors when a person other than the originator will act as servicer of the uncollected debts. After receiving notice of the assignment, a debtor can only discharge the debt by paying the assignee.<sup>193</sup>

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to debtors who end up paying the wrong person. (2) There is no duty on the second assignee to enquire whether previous assignments were made. This operates especially harshly in the situation where the first assignment was for future claims and the first assignee could not give notice to the debtors before the claims came into existence. (3) The rule requires no specific attributes in the notice to the debtor. For instance, the notice need not state that the debtor can now only validly discharge the debt by paying the assignee. Should the debtor not realise that this is the position, he may become liable twice for the same debt. (4) The rule does not require that the notice must be in writing, which could prejudice the debtor who forgets about the notice and pays the wrong person. (5) The rule is illogical, because if a debtor receives notice by chance of an earlier assignment it will be enough to ensure the priority of the earlier assignment. However, if the debtor receives notice by chance of a later assignment, this will not provide the later assignment priority over the earlier assignment. (6) The rule is harsh when applied to assignments of future claims. Notice can only be given to debtors of future claims when they come into existence. This is so because the principle at the root of *Dearle v Hall* is that notice to debtors is equivalent to possession. Possession cannot be taken before the expectancy has materialised. (7) When there is an assignment of claims from many debtors, compliance with the rule in *Dearle v Hall* becomes difficult and costly. See also Fidelis Oditah "Priorities: Equitable versus Legal Assignments of Book Debts" (1989) 9 *Oxford Journal of Legal Studies* 513 at 525–527. The UK Law Commission *Registration of Security Interests* at 194 suggested that the assignment of book debts in the course of a securitisation scheme should be registrable in order to give third parties notice of the transfer. This would effectively disable the rule in *Dearle v Hall*, which was seen by the Law Commission as an obstacle to certain securitisations (at 175–176). Although these recommendations were retained in the Law Commission's *Final Report* at 31 and 109 (par 4.18), no further progress has been made in this regard.

<sup>192</sup> *Bence v Shearman* [1898] 2 AC 367 at 382. This position is left unchanged by the Law Commission's recommendations in its *Final Report* at 107 (par 4.11).

<sup>193</sup> *William Brandt's Sons & Co v Dunlop Rubber Co Ltd* [1905] AC 454 (HL) at 460–461.

- Debtors without notice can continue to acquire new defences and to rely on set-offs.<sup>194</sup>
- The originator and the debtors can agree to vary the terms of their original agreement. Again, this will be prohibited by the transaction agreements and reliance is placed on compliance by the originator.
- It may be necessary to join the originator in any legal action taken against the debtor.<sup>195</sup>

### 3.3.2.2 Charge in favour of debenture trustee

In paragraph 3.2 I explained the distinction between legal and equitable security. When the security grantor only holds an equitable right in the property that is offered as security, only an equitable security may be granted over such assets. Since the SPV obtains the claims by way of an equitable assignment, it cannot provide legal security over the claims but only equitable security, in other words, a charge.

Security over the assets of the SPV is granted as far as possible by way of a fixed charge.<sup>196</sup> All proceeds of the collection of the claims transferred to the SPV will be required to be deposited into a designated bank account. The benefits arising from the credit enhancement agreements will also be subject to a fixed charge in favour of the investors in the SPV. There may, however, also be floating charges, for instance, a charge provided over the bank account of the SPV.<sup>197</sup> However, many of the problems encountered in connection with the floating charge will be of lesser significance during a securitisation transaction, since the SPV will have no, or very few, other

<sup>194</sup> McCormack *Secured Credit* at 226 and 234. See further *Marathon Electrical Manufacturing Corp v Mashreqbank PSC* [1997] 2 BCLC 460 (QBD) at 469–470; *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 2 All ER 741 (Ch) at 748. The assignee cannot be in a better position by virtue of the assignment than the assignor, therefore if the debtor had any right to set-off against the assignor, the assignee will take the book debts subject to these rights. See also Glennie *et al Securitization* at 193. This position is left unchanged by the Law Commission's recommendations in its *Final Report* at 107 (par 4.11).

<sup>195</sup> A legal assignee can sue the debtor in his own name without involving the assignor, but an equitable assignee must join the assignor as co-plaintiff if he is willing to co-operate, or as co-defendant when he is not. See *Weddell v JA Pearce & Major* [1988] Ch 26 at 40G–H where the Court held that the joinder of the assignor in an equitable assignment has a practical reason, namely to ensure that the debtor will receive a full discharge by payment to the equitable assignee. An action instituted without joinder is not a nullity, but will be stayed until joinder. See also *Performing Right Society Ltd v London Theatre of Varieties Ltd* [1924] AC 1 at 14, 19 and 31; *Raffaelsen Zentralbank Österreich AG v Five Star General Trading LLC* [2001] 3 All ER 257 (CA) at 277J–278A; McCormack *Secured Credit* at 224–225; *Peel Contract* at 717–718.

<sup>196</sup> Lightman *et al Administrators* at 71–72.

<sup>197</sup> Norton *et al Asset Securitization* at 55.

creditors apart from the investors.<sup>198</sup> Even if there is a fixed charge over the bank account, it should be easy for an SPV to acquire the consent of the trustee for debenture-holders to make limited withdrawals for pre-determined expenses.

### 3.3.2.3 Recharacterisation of sale as security

There is virtually no risk in English law that a properly documented sale of claims will be recharacterised as a security for a loan. This is the case even if the SPV has recourse against the originator for unpaid claims,<sup>199</sup> and even though the economic effect of the transaction is similar to a loan secured by claims. It makes no difference that the originator may repurchase assets from the SPV, that the originator is paid a fee to service collection or that it acts as an agent for the SPV to collect the claims.

If it is argued that a written document does not represent the agreement between the parties, in other words, that it is a sham, the court will have regard to all evidence that show that the parties had a common intention to enter into a different transaction than the one described in the document.<sup>200</sup> However, usually it is not contended that the written document is a sham, but only that the inconsistencies in the document show that the document had a different objective to that which the parties described. In the absence of an allegation that the agreement was a sham, the court will only have regard to the written document. The court will consider the written agreement as a whole to determine the true nature of its provisions.<sup>201</sup> Consequently, if the transaction agreements convey an intention to sell the claims to the SPV, the courts will give effect to this intention. Put somewhat differently: even if the objective of a transaction is financing, the court will pay attention to the method in which the finance is provided. If the method is by way of a sale of claims, the fact that the purpose of the transaction is to advance money will not convert the character of the transaction into a loan.<sup>202</sup>

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<sup>198</sup> *Wood Project Finance* at 150.

<sup>199</sup> *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA) at 168A–C; *Wood Project Finance* at 159; *McCormack Secured Credit* at 228.

<sup>200</sup> *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA) at 186C–188D.

<sup>201</sup> *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA) at 161G and 163I–169F.

<sup>202</sup> *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA) at 168F; *Lloyds & Scottish Finance Ltd v Cyril Lord Carpets Sales Ltd* [1992] BLCL 609 (HL) at 615I–616A and 619C–I, citing with approval *Re George Inglefield Ltd* [1933] 1 Ch 1 (CA); *Olds Discount Co Ltd v Cohen* [1938] 3 All ER 281 and *Olds Discount Co Ltd v Playfair Ltd* [1938] 3 All ER 275 (KBD).



In a very interesting article on the subject of recharacterisation, Berg<sup>203</sup> argues that the decisions in *Brumark*<sup>204</sup> and *Coslett*<sup>205</sup> show a shift in the approach of English courts in categorising a transaction.<sup>206</sup> These decisions held that categorisation is done in two stages. In the first stage the court determines the intention of the parties as it appears from the transaction documents. During the second stage the court categorises this intention as a matter of law.<sup>207</sup> The second stage of the enquiry restricts the autonomy of the parties to the agreement. Berg further shows that English courts have included a policy element in their categorisation of transactions.<sup>208</sup> He then questions whether the courts will still follow the approach of neutrality towards off-balance sheet transactions as followed in *Welsh Development Agency*.<sup>209</sup> He argues that corporate collapses such as Enron, as well as other cases that showed the risks associated with these kinds of transactions, might lead English courts to take a more conservative policy approach when categorising the assignment of book debts as either charges or sales.<sup>210</sup>

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In the last decision the Court held: “it is the nature of the agreement entered into, and not its object, at which the court has to look in order to decide whether in any particular case the agreement is a moneylending agreement or otherwise’ (at 227).

<sup>203</sup> Alan Berg “Recharacterisation After Enron” (2003) *J of Business Law* 205.

<sup>204</sup> *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC). See the detailed discussion in par 3.2.1.1. The decision of the Privy Council was followed by the House of Lords in *Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41 after the article by Berg was published. This decision lends further support to the Berg’s arguments.

<sup>205</sup> *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL).

<sup>206</sup> Berg 2003 *JBL* at 221–232. McKnight 2006 *JBLR* at 501 is also of the opinion that there is such a shift in the approach of the English courts. The author argues that assignments of book debts that have the economic effect of a loan, which will include securitisation, should be treated as secured transactions. In my view, the author confuses two issues: while the filing of a sale of book debts will help to publicise the transaction to potential third party creditors of the assignor, and while the time of filing of such an assignment may be applied to determine the priority between successive assignments of the same book debts, this does not mean that the assigned book debts should still fall in the estate of the assignor. The filing system should rectify problems surrounding notice to third parties and priority. It should not serve as a reclassification of transactions. McKnight’s suggestion is directly in contrast with the position in the USA, where a sale of accounts leads to their effective removal from the estate of the seller. See par 4.2.2.

<sup>207</sup> See *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC) at [31]–[32] and *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 AC 336 (HL) at [53], following the approach in *Brumark*. Both judgments considered the characterisation of charges, but the reasoning employed by the Court remains interesting for the future characterisation of sales of book debts.

<sup>208</sup> Berg 2003 *JBL* at 232–234.

<sup>209</sup> *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 (CA), which involved block-discounting.

<sup>210</sup> Berg 2003 *JBL* at 237–238.

However, in my opinion there are also important policy considerations in favour of finding a sale of book debts during a securitisation transaction as a true sale rather than a charge. Securitisation has become an important method of financing in England.<sup>211</sup> The London Stock Exchange is an important forum for the issue of asset-backed securities for issuers world-wide.<sup>212</sup> Investors have confidence in investing in asset-backed securities issued via this forum, because they believe that their interests are protected by the structure of the scheme, their security over the assets of the SPV and, finally, by the law.

If the courts should fail them and hold that the sale of assets by the originator to the SPV was not a true sale but only an attempt at granting security for a loan, it would have disastrous consequences for these investors. The assignment of the assets to the SPV would only be an unregistered charge, which would mean that the debt securities issued to investors in the SPV will be unsecured. It will further leave the securities issued by the SPV vulnerable to the insolvency of the originator. The investors would have accepted lower interest rates on the securities in the SPV, because of their reliance on the fact that the risk of default of the SPV is separated from the business risks of the originator.<sup>213</sup> The securities would have received a better rating on the strength of the legal opinion that the SPV is insolvency-remote from the originator. If the sale of the assets to the SPV is recharacterised as a loan, the investors will be under-compensated in terms of interest.

The investors in these securities will often be institutional investors. Institutional investors, such as pension funds and insurance companies, represent a large proportion of the general public. In other words, when the institutional investors stand to lose their investment, it is really the general public who stand to lose their savings. This ought to be an important consideration when the characterisation of securitisation transactions comes before the courts.

As a result, I do not think that the shift in the approach of the courts in categorising transactions will lead to a different outcome for the characterisation of a sale and

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<sup>211</sup> In the first nine months of 2006 the UK originated £154 billion worth of assets in securitisation schemes, which represented 54% of the European securitisation market. See [www.europeansecuritisation.com/ESFDataRprt1006.pdf](http://www.europeansecuritisation.com/ESFDataRprt1006.pdf) (accessed 29 January 2008).

<sup>212</sup> See [www.londonstockexchange.com](http://www.londonstockexchange.com) (accessed 29 January 2008).

<sup>213</sup> See pars 2.2.3 and 2.2.4.

assignment of book debts to an SPV during a securitisation scheme. In most cases these transactions should be characterised as true sales.

### 3.3.2.4 Non-assignment clauses

Non-assignment clauses, meaning agreements between debtors and creditors that the latter will not assign the debt arising from the agreements, are allowed by English law.<sup>214</sup> Such clauses are not considered contrary to public policy, because the debtor can have several legitimate commercial reasons for inserting such a clause in the first place.<sup>215</sup>

Goode<sup>216</sup> voiced the opinion that an assignment in contravention of a non-assignment clause could, however, still have effect between the assignor and the assignee. The implication of this is that the debtor will not deal with anyone but his original creditor, but that the assignor will be obliged to account to the assignee for anything he receives from the debtor. In Goode's opinion a provision in an agreement that aims to prevent this consequence will be void. Although accepting large parts of Goode's other arguments on the issue of non-assignment clauses,<sup>217</sup> the House of Lords in *Linden Gardens* did not express a view on this argument.<sup>218</sup> If Goode's argument is accepted, non-assignment clauses in the agreement between the debtor

<sup>214</sup> *Linden Gardens Ltd v Lenesta Sludge* [1994] AC 85 (HL). See also Andrew McKnight "Contractual Restrictions on a Creditor's Right to Alienate Debts: Part I" (2003) 18 *J of Int Banking Law* 1; Andrew McKnight "Contractual Restrictions on a Creditor's Right to Alienate Debts: Part II" (2003) 18 *J of Int Banking Law* 43.

<sup>215</sup> *Linden Gardens Ltd v Lenesta Sludge* [1994] AC 85 (HL) at 106–107. McKnight 2003 *JIBL* at 3 advances some of these reasons, for instance: (1) The debtor may wish to retain rights of set-off, not only with regard to the transaction giving rise to the claim, but also with regard to present and future claims of a more general nature. (2) If the debtor overlooks a notice of the assignment and he pays the assignor, he will not obtain a good discharge. (3) The assignee may be a person with whom the debtor does not wish to deal, or the debtor may wish to only deal with the assignor, because of their special working relationship.

<sup>216</sup> RM Goode "Inalienable Rights?" (1979) 42 *Modern Law Review* at 554–555. The author criticises the decision *Helstan Securities Ltd v Hertfordshire County Council* [1978] 3 All 262, where the Court in an *obiter dictum* appeared to have accepted that an assignment in contravention of a non-assignment clause would also render the assignment between the assignor and assignee ineffective. See also Goode *Legal Problems* at 106–110; McCormack *Secured Credit* at 230; Odith *Receivables Financing* at 260; Wood *Project Finance* at 133; Peel *Contract* at 738.

<sup>217</sup> *Linden Gardens Ltd v Lenesta Sludge* [1994] AC 85 (HL) at 104–107.

<sup>218</sup> *Linden Gardens Ltd v Lenesta Sludge* [1994] AC 85 (HL) at 107.

and the originator should not have a significant practical effect, since the originator mostly acts as the agent of the SPV in collecting the debts.<sup>219</sup>

There are also other views on non-assignment clauses that would leave a purported assignment totally void. According to McKnight,<sup>220</sup> it is possible for a non-assignment clause to prohibit the transfer of any proprietary interest in the claim and of its fruits, in other words, payment in terms of the claim, which would leave a purported assignment worthless between the assignor and the assignee too. The author sees such a restriction as changing the nature and character of the claim as an asset of the creditor, so that it becomes impossible to assign the claim.<sup>221</sup>

The restriction actually forms an integral part of the definition of that property. In other words, the nature and character of the creditor's property is the benefit or rights, the chose in action, that it has under the contract and the restriction goes to defining and limiting the scope of the chose.

According to McKnight, the interpretation of the non-assignment clause will depend on the terms of the clause and a purported assignment will not be void in all circumstances. However, if a claim that is subject to a restriction as envisaged by McKnight in the quotation above is purportedly assigned to the SPV during a securitisation scheme, the assignment will be void. If only a few of the assignments were void by reason of such non-assignment clauses, the securitisation scheme will probably be able to withstand the loss of those assets. However, it could have devastating consequences for the scheme if such clauses were standard to the security agreements that gave rise to the claims transferred to the SPV. Consequently, the underlying agreements to the claims to be assigned must be carefully examined at the beginning of the securitisation transaction to avoid the use of claims that might fall under this category of restriction.

The Law Commission's *Final Report on Company Security Interests* recommended that prohibitions on the assignment of receivables should not be effective against the assignee, thereby accepting Goode's suggestion.<sup>222</sup> However, 'receivable' is defined narrowly and does not include loan agreements, but only

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<sup>219</sup> Although not settled in English law, it seems that an assignment in spite of a non-assignment clause will lead to a claim by the assignee against the assignor for breach of contract. See Oditah *Receivables Financing* at 260–262.

<sup>220</sup> 2003 *JIBL* at 46.

<sup>221</sup> McKnight 2003 *JIBL* at 47.

<sup>222</sup> At 30 and 113 (par 4.40). See McKnight 2006 *JIBLR* at 595–596 for criticism of the proposals of the Law Commission.

claims arising from the supply of goods and services by a company to a third party.<sup>223</sup> In other words, non-assignment clauses in mortgage agreements will remain unaffected by the proposals of the Law Commission. If the recommendations of the Law Commission ever become law, this provision will benefit securitisation where the asset type is the trade receivables of the company.

The interpretation of non-assignment clauses is therefore not settled in English law and holds some risks for securitisation. The best option remains to use claims of which the underlying agreements are standardised and do not contain non-assignment clauses.

### 3.3.3 Bankruptcy-remoteness from originator

The SPV must be insulated from the insolvency of the originator. Otherwise the investors in the securities issued by the SPV will not only be exposed to the risk associated with the assets that back those securities, but also to the risks associated with the business of the originator. There are four requirements that must be met before an SPV will be bankruptcy-remote from the originator:<sup>224</sup>

- 1 The assignment must be effective on the insolvency of the originator, regardless of a lack of notice to the debtors. An equitable assignment does not require notice to debtors and this requirement is therefore not an obstacle in English law to a finding of bankruptcy-remoteness.<sup>225</sup>
- 2 The SPV must not be consolidated with the originator on the latter's insolvency so that all the assets and liabilities of the SPV are merged with that of the originator. This is not a real risk in English law. English courts will also not easily recharacterise the sale of the assets as a non-registered secured loan.<sup>226</sup>
- 3 There should be no material loss or delay in the recovery of the funds collected by the originator as servicer if it becomes insolvent. This risk is easily curbed by requiring frequent turnover of received funds to the SPV.
- 4 Transfers or payments by the originator to the SPV must not be set aside during the insolvent liquidation of the originator as preferences or as transactions at an undervalue. If set aside, the creditors of the originator will have a claim against

<sup>223</sup> See my comments in n 187.

<sup>224</sup> Wood *Project Finance* at 159–160.

<sup>225</sup> See par 3.3.2.1.

<sup>226</sup> See par 3.3.2.3.

the transferred assets. However, as shown in the discussion below I do not regard this as a real threat in English law. A sale of assets for which full market value is received in consideration will not usually be held to be preferential. If the sale of the assets were at a discount, or if there was a deferred amount of the sale price which never materialised, this might be an indication of preference or undervalue.

### 3.3.3.1 Transactions at an undervalue

Section 238 of the Insolvency Act 1986<sup>227</sup> provides for the avoidance of transactions at an undervalue. The section is only applicable after the company enters administration or liquidation.<sup>228</sup> Where a company has at the relevant time<sup>229</sup> entered

<sup>227</sup> c 45, hereinafter referred to as ‘the Act’. For an extensive discussion of s 238, see John Armour & Howard Bennett (eds) *Vulnerable Transactions in Corporate Insolvency* (2003) at 37 *et seq.*

<sup>228</sup> Section 238(1). See also Roy Goode *Principles of Corporate Insolvency Law* 3 ed (2005) at 414–415.

<sup>229</sup> According to s 240, the relevant time is between the time of the transaction and the “onset of insolvency”. In the case of transactions at an undervalue, this time is two years regardless of whether the person to whom the payment was made was unconnected with the company (s 240(1)(a)). The onset of insolvency is described in s 240(3): (a) If the company went directly into liquidation, it is the date of commencement of winding-up, which is the date on which the resolution was passed if it is a voluntary winding-up, or the date on which the petition is presented to court where it is a compulsory winding-up. (b) If the company went into administration due to an administration order, the date on which the administration application is made. (c) If an administrator was appointed by the holder of a floating charge, the directors of the company, or by the company, the date of the filing of the notice at the Court of their intention to make such an appointment. (d) If an administrator was appointed in another way than already described, on the date that the appointment takes effect. (e) If the company goes into liquidation after an administration order has taken effect, the date of the administration order’s onset, as described in the previous points, is the onset of insolvency. The relevant time for transactions between the company and a connected person is two years, and for persons unconnected with the company, six months (s 240(1)). The time is only a relevant time if the company is at that time unable to pay its debts or becomes unable to pay its debts as a result of the transaction or preference. The circumstances under which a company is deemed unable to pay its debts are set out in s 123. In terms of s 240(2) when a transaction at an undervalue is entered into with a connected person, the company is presumed to be unable to pay its debts. See in this regard Louis Doyle & Andrew Keay *Insolvency Legislation: Annotations and Commentary* (2005) at 130–133 and 277. On the relevant time generally, see Harry Rajak *Company Liquidations* (2006) at 292–295; Andrew Keay & Peter Walton *Insolvency Law: Corporate and Personal* (2003) at 480–483; Ian F Fletcher *The Law of Insolvency* 3 ed (2002) at 690–692; Goode *Principles* at 416; Armour & Bennett *Vulnerable Transactions* at 48–55. On the onset of insolvency, see Doyle & Keay *Insolvency Legislation* at 278; Goode *Principles* at 417. ‘Connected with a company’ is defined in s 249 as a director or a shadow director of a company or an associate of such a director or shadow director, or as an associate of the company. A shadow director is a person in accordance with whose directions the directors of the company are accustomed to act (s 251). A similar definition appears in s 741(1) of the Companies Act 1985 and in s 22(5) of the Company Directors Disqualification Act 1986 (c 46). See also *Secretary of Trade & Industry v Deverell* [2000] 2 All ER 365 (CA); *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 (Ch); Natania Locke “Shadow Directors: Lessons from Abroad” (2002) 14 *SA Merc LJ* at 420. It is more likely that the originator will be a shadow director of the SPV than the other way round. An ‘associate’ is defined in s 435(6) with reference to two companies, as where the same person or associated persons have control of both companies, or with reference to the company and another person, where the other person or the other person and his associates have control of the company (s 435(7)). It is unlikely that the SPV will

into a transaction at an undervalue, the administrator or liquidator may apply to court for an order.<sup>230</sup> The court may make an order that it deems fit for restoring the position to what it would have been if the company did not enter into the transaction.<sup>231</sup>

A transaction is considered to be at an undervalue if the company<sup>232</sup>

- makes a gift to that person or receives no consideration for what they give or transfer to that person; and
- enters into a transaction with that person for a consideration, the value of which, in money or money's worth, is *significantly* less than the value of the consideration provided by the company.

In the context of a securitisation scheme, the originator will always be compensated by the SPV for the transfer of the assets. Therefore, the transfer will not be considered a gift. Only the second of the situations listed above need therefore be considered.

'Transaction' is defined broadly and will include the purchase of the assets by the SPV.<sup>233</sup> The more difficult aspect to prove will be whether the transaction was at an undervalue. The office holder, who is either the administrator or the liquidator, must prove the values of the respective considerations and that which was received was significantly less than what was provided.<sup>234</sup>

The adequacy of the consideration is therefore under scrutiny.<sup>235</sup> The valuation of the consideration is of great importance in order to determine its adequacy.<sup>236</sup> In

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have control over the originator, so an association based on s 435(7) is unlikely. It is more likely that the same persons control both the originator and the SPV, which will mean that an association in terms of s 435(6) may be found to exist.

<sup>230</sup> Section 238(2).

<sup>231</sup> Section 238(3).

<sup>232</sup> Section 238(4).

<sup>233</sup> *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143 (HL) at 150–151([20]). According to the Court the emphasis is not on whether there was a transaction, but on whether there was consideration. See further Doyle & Keay *Insolvency Legislation* at 268; Goode *Principles* at 421–423. 'Transaction' has a broader meaning than 'contract'. A series of contracts and acts may together constitute a 'transaction'. These will be considered together for purposes of determining the value of the consideration. See Armour & Bennett *Vulnerable Transactions* at 55, 60–63 and 68. In the context of securitisation it therefore seems likely that the Court will not only consider the sale of the assets to the SPV and the amount paid to the originator in return, but also aspects such as the originator's involvement after the initial sale.

<sup>234</sup> *Re MC Bacon Ltd* [1990] BCLC 324 (Ch) at 340–341. The benefits received must be valued at the time of the transaction. See Goode *Principles* at 429–430.

<sup>235</sup> Armour & Bennett *Vulnerable Transactions* at 70.

securitisation it will usually be possible to place a monetary value on the consideration provided by the SPV and to ascertain a market value for the transferred assets. The court will consider all aspects of the transaction to determine whether there was equality of benefit.<sup>237</sup> For instance, if the terms of the agreement stipulated a deferred payment in respect of a part of the sale, for which no interest is charged, this might be an indication of undervalue.<sup>238</sup> Furthermore, assets are often sold to the SPV at a discount in order to effect over-collateralisation or to create a reserve fund, both of which serve as credit enhancement.<sup>239</sup>

Even if the transaction is found to be at an undervalue, in my opinion avoidance of a securitisation transaction in terms of section 238 will still fail for two possible reasons. First, reliance on section 238 might fail because the difference in value is not significant.<sup>240</sup> Second, the exception in section 238(5) will apply to most securitisation schemes.

In terms of section 238(5), the court will not make an order if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and that at the time there were reasonable grounds for believing that the transaction would benefit the company. The first part of this exception is very difficult for an administrator or liquidator to disprove, because it is concerned with the

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<sup>236</sup> For the valuation of consideration generally, see *Armour & Bennett Vulnerable Transactions* at 72–78. Value is more easily determinable when there is a ready market for the assets than when they are unique. When the assets are unique, a procedural test is employed instead, namely that where the parties acted at arm's length between a willing buyer and a willing seller, after proper marketing, and both parties acted knowledgeably, prudently and without compulsion, then the price will be presumed to be the assets' market value. See *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143 (HL) at 154 ([30]). *Armour & Bennett Vulnerable Transactions* at 74 are of the opinion that when the seller is in financial distress at the time of the sale of the assets, a fair market value would be lower than under normal circumstances and that the court should take this into account when determining if the transaction was at an undervalue. They are further of the opinion that when there is a sale of assets of which the value is uncertain at the time of the purchase, for example, a sale of claims where it is uncertain whether the debtor will default, a discount in the price will be warranted (at 75). This is important for our discussion, because the sale of the assets to the SPV will often contain a form of discount to reflect this uncertainty.

<sup>237</sup> *Agricultural Mortgage Corporation plc v Woodward* [1995] 1 BCLC 1 (CA) at 11. See also Goode *Principles* at 428–429. Where the value of the consideration provided to the company is a matter of speculation, the onus is on the party who opposes the application in terms of s 238 to prove its value. See *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143 (HL) at 153 ([27]).

<sup>238</sup> See *Doyle & Keay Insolvency Legislation* at 270, *Wood Project Finance* at 160.

<sup>239</sup> See par 2.5. However, see my comments in n 236.

<sup>240</sup> The meaning of 'significant' has not yet been determined by the courts. See *Keay & Walton Insolvency Law* at 489. However, taking into account the first part of the test for undervalue, one may assume that the discrepancy must be such that it evidences a gift or an intention of transferring value without receiving anything in return.



subjective state of mind of the officers of the company when they entered into the transaction. Consequently, most administrators or liquidators will seek to show that there were no reasonable grounds to believe that the transaction would be to the benefit of the company, which is an objective test.<sup>241</sup>

I believe that an SPV will be able to rely on this exception, except in the most extraordinary of circumstances. Even if the originator was in a doubtful financial position at the time of the securitisation transaction, the benefits of a successful securitisation scheme as set out in Chapter 2 would satisfy the second leg of the exception.<sup>242</sup> The enhancement of the liquidity of the originator, which is one of the advantages discussed in Chapter 2, might be one of the key considerations for an originator in financial difficulty and will also show that the originator entered into the transaction with a view of carrying on its business.

Despite the fact that section 238 provides that a court *shall* make an order when the requirements of the section are met, there is case law that suggests that the court retains a discretion not to make an order if the company in liquidation would be in a worse situation after restoration in terms of the section.<sup>243</sup> It will be very difficult to put the originator in the same position as before the transaction. The court will try to reverse the transactions, in other words, the originator will have to return any consideration received for the sale of the assets and the SPV will have to return the assets to the originator.

A reversal of a securitisation transaction will be very hard to achieve. Section 241(2) protects third parties who acquired interests in property from a person other than the company in good faith and for value from prejudice by the court's

<sup>241</sup> See Keay & Walton *Insolvency Law* at 490; Doyle & Keay *Insolvency Legislation* at 270; Armour & Bennett *Vulnerable Transactions* at 79. The onus is on the person who seeks to prevent an order in terms of s 238 to prove that all the elements of s 238(5) are met. See Fletcher *Insolvency* at 688. It is therefore advisable when the seller (originator) is in a doubtful financial position, for the purchaser (SPV) to request a signed memorandum from the board of directors of the seller (originator) where the board state their reasons for entering into the transaction and why they consider it for the benefit of the company. See Armour & Bennett *Vulnerable Transactions* at 79. If the SPV needs to make use of this defence in later proceedings, it will then have proof readily available.

<sup>242</sup> See par 2.2 *et seq.*

<sup>243</sup> See *Re Paramount Airways Ltd* [1993] Ch 223 (CA) at 239; *Re MDA Investment Management Ltd* [2004] 1 BCLC 217 (Ch) at 264–265. See further Doyle & Keay *Insolvency Legislation* at 270–271; Keay & Walton *Insolvency Law* at 492; Goode *Principles* at 441; Armour & Bennett *Vulnerable Transactions* at 83.

order.<sup>244</sup> The court may further not order that such a person must return any benefit received from such an interest to the office holder. The investors in the SPV will be in this position: they received interests in the transferred assets by way of security over those assets, for value and while acting in good faith. It follows that the court will not order that they be divested of their security rights in those assets or that they return any payment already received on their investment. Even if the assets are returned to the estate of the originator, the investors will retain their security over the assets. Depending on the time that lapsed between the transfer of the assets and a successful application in terms of section 238, it might well be that the value of the assets has reduced substantially since the transfer and that the originator does not have the consideration received in return for the transfer readily available. Considering all these factors, and in the unlikely event that all the other requirements of section 238 are met, I think that the court may well decide to exercise its discretion against an order, because it will leave the insolvent originator in a worse situation than before.

### 3.3.3.2 Preferences

Where a company has at a relevant time given a preference to any person, the office holder may apply to court to make an order in terms of section 239 of the Act.<sup>245</sup> The court shall make an order it thinks fit for restoring the position to what it would have been if the company had not given the preference.

A company gives a preference to a person if:<sup>246</sup>

- (a) that person is one of the company's creditors or a surety or a guarantor for any of the company's debts or other liabilities; and
- (b) the company does anything or suffers anything to be done which, after the company goes into insolvent liquidation, has the effect of putting that person in a better position than he would have been in if that thing had not been done. In other words, the creditor was paid more than he would have been paid during the winding-up of the company.

The court will only make an order in terms of section 239 if the company acted with the desire to put the person in a better position than he would have been in, if it were

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<sup>244</sup> See Doyle & Keay *Insolvency Legislation* at 282; Fletcher *Insolvency* at 693–694; Goode *Principles* at 450–453.

<sup>245</sup> 'Relevant time' for purposes of s 239 carries the same meaning as for s 238. See n 229 for a full discussion of this term. The relevant time for preferences made to unconnected persons is only six months in comparison to the applicable two year period if made to connected persons. See s 240(1)(b). For an extensive discussion of preferences, see Armour & Bennett *Vulnerable Transactions* at 123 *et seq.*

<sup>246</sup> Section 239(4).

not for the action by the company.<sup>247</sup> If the person was connected with the company, the company is presumed to have had this intention.<sup>248</sup>

In my opinion, the SPV will not qualify as a creditor for purposes of this section. The word ‘creditor’ is not defined, but most authors argue that it carries the same meaning as in the rest of the Act, namely someone who can prove a debt in the winding-up of the company.<sup>249</sup> Walters<sup>250</sup> argues that the person to whom the payment is made must be the creditor of the debtor in the sense that he extended credit to the debtor. So, for instance, where goods are supplied to the company on a cash-on-delivery basis, payment of the amount on delivery of the goods will not be a preference, because the supplier was not at any time a creditor of the company. The same will apply when the goods are only supplied when payment is received in advance. If security is granted to a person for a contemporaneous or subsequent advance, that person does not obtain a preference, since the granting of the security is matched by the granting of new funds. This view is also held by Goode.<sup>251</sup>

During most securitisation transactions the SPV will rather be a debtor of the originator than a creditor, because the assets will be transferred to the SPV marginally before payment is made to the originator. There may also be a small part of the sales price that is deferred until the transferred claims are collected.

As discussed above, the risk of recharacterisation of the sale of the assets to the SPV as a secured loan is very small in English law. If a recharacterisation is ordered by a court, the SPV will be a creditor of the originator for purposes of section 239. However, it would not make sense to launch an application in terms of section 239 after the recharacterisation of the securitisation transaction. The only preference given to the SPV under such circumstances would be the constructive charges over the assets in favour of the SPV. Since the non-registration of the charges over the assets

<sup>247</sup> Section 239(5). See also Doyle & Keay *Insolvency Legislation* at 273–274; Keay & Walton *Insolvency Law* at 498–504; Fletcher *Insolvency* at 690; Rajak *Company Liquidations* at 289–292.

<sup>248</sup> Section 239(6). ‘Connected person’ has the same meaning as in the interpretation of s 238. See n 229.

<sup>249</sup> See Doyle & Keay *Insolvency Legislation* at 272, with reference to rr 12.3 (provable debts) and 13.12 (‘debt’, ‘liability’ (winding-up)) of the Insolvency Rules 1986, SI 1986/1925. See further Goode *Principles* at 461; Armour & Bennett *Vulnerable Transactions* at 139.

<sup>250</sup> Armour & Bennett *Vulnerable Transactions* at 138.

<sup>251</sup> Goode *Principles* at 463–466.

will in any case lead to their invalidity,<sup>252</sup> there will be no need for an office holder to undo charges over those assets by way of a section 239 application.

### 3.3.3.3 Transactions that defraud creditors

Sections 423 to 425 of the Act are aimed mainly at the actions of individuals, where they part with their property for little or no consideration in order to put it beyond the reach of their creditors.<sup>253</sup> However, those sections can also be used by an office holder of an insolvent company that entered into such transactions before its insolvent liquidation or administration. Section 423 reads substantially the same as section 238 in that the applicant must show that the transaction was at an undervalue.<sup>254</sup> Section 423 does not offer the office holder any benefits above an application in terms of section 238 when the company is under insolvent liquidation.

An application under sections 423 to 425 differs from an application under section 238 in two respects. First, any person prejudiced or capable of being prejudiced by the transaction may launch the application and not only the administrator or liquidator.<sup>255</sup> Second, the application can be brought outside the insolvency of the company.<sup>256</sup>

The applicant must prove that the purpose of the transaction was to put the assets of the company out of reach of its creditors, which is a subjective measure and difficult to prove, especially in the case of a securitisation scheme where the transaction usually has a commercial motivation.<sup>257</sup>

I therefore do not think that this section is any real threat to the bankruptcy-remoteness of the SPV.<sup>258</sup>

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<sup>252</sup> See par 3.2.6 n 154–158.

<sup>253</sup> See *Rajak Company Liquidations* at 302; *Keay & Walton Insolvency Law* at 506; *Fletcher Insolvency* at 244.

<sup>254</sup> See the discussion in par 3.3.3.1 for the difficulty in establishing that a securitisation transaction was at an undervalue.

<sup>255</sup> Section 424, which refers to such a person as the ‘victim’.

<sup>256</sup> See *Goode Principles* at 415, 504.

<sup>257</sup> Despite the title of section 423, and contrary to its predecessors, it is not necessary to prove intent to defraud. See *Keay & Walton Insolvency Law* at 511; *Fletcher Insolvency* at 244.

<sup>258</sup> On transactions defrauding creditors in general, see *Doyle & Keay Insolvency Legislation* at 516–522; *Keay & Walton Insolvency Law* at 506–513; *Fletcher Insolvency* at 243–246; *Rajak Company Liquidations* at 302–304; *Goode Principles* at 503–505; *Armour & Bennett Vulnerable Transactions* at 95–121.

### 3.4 CONCLUSION

After the decision of the House of Lords in *Spectrum Plus Ltd v National Westminster Bank plc*<sup>259</sup> a charge over the book debts of a company in English law will mostly be in the form of a floating charge. The Court held that it was possible to create a fixed charge over the chargor's book debts, but that the charge agreement would then need to place restrictions on the ability of the chargor to deal with the proceeds of the book debts after their collection.<sup>260</sup> Such restrictions will leave a company without access to its cash. A fixed charge over a large part of a company's book debts is therefore not a viable option.

The only alternative available to a company is to grant a floating charge over its book debts. However, the floating charge has many disadvantages compared to other forms of security, of which the weak priority it provides to its holder is the most important. These disadvantages make the floating charge an unattractive form of security for a prospective lender.<sup>261</sup> Previously, a floating charge holder could at least appoint an administrative receiver who, in turn, could block an application for an administration order, but the ability to appoint an administrative receiver was restricted by the Enterprises Act 2000.

Although I could find no quantitative research on this topic, one wonders to what extent this lack of an effective security over claims in England encouraged the growth of securitisation as a financing form.

Compared to the uncertainty experienced in English law in granting security over book debts, the sale of book debts by way of assignment is more certain. The transfer of book debts by an originator to an SPV will take the form of an equitable assignment, for which notice to debtors is not a requirement.<sup>262</sup> However, the lack of notice to the debtor does hold certain dangers, of which the application of the rule in *Dearle v Hall*<sup>263</sup> is possibly the most serious.<sup>264</sup> If an assignor assigns the same book debt to more than one assignee, the assignee who first gives notice to the debtor will

<sup>259</sup> *Spectrum Plus Ltd v National Westminster Bank plc* [2005] UKHL 41.

<sup>260</sup> See par 3.2.1.1.

<sup>261</sup> See par 3.2.6.

<sup>262</sup> See par 3.3.2.1.

<sup>263</sup> (1828) 3 Russ 1.

<sup>264</sup> See par 3.3.2.1.

have priority above the other, regardless to whom the debt was first assigned, as long as the second assignee does not have knowledge of the first assignment. The rule finds equal application when the book debts that are subject to a fixed charge are subsequently assigned.<sup>265</sup> In the rare instances where the originator is not the servicer of the transferred book debts, the possibility remains that the debtor will discharge his debt by payment to the originator if the debtor did not receive notice of the assignment. It is therefore necessary to instruct the debtor under such circumstances to make payment to the servicer.

The risks associated with the lack of notice to the debtor are usually dealt with in the transaction documents of the securitisation scheme. However, they are dependent on the adherence by the originator to the terms of these agreements.

One consequence of assigning the book debts to the SPV by way of an equitable assignment is that the SPV will only be able to grant equitable security to the investors in the securities.<sup>266</sup> Mostly such security takes the form of fixed charges, although there may be floating charges over specific assets, such as the bank account into which the servicer deposits the proceeds of the book debts.

It is very unlikely that an assignment of book debts would be recharacterised as a secured loan, where it is clear that the intention of the parties was to transfer the book debts outright to the estate of the assignee.<sup>267</sup> English courts have repeatedly held that the effect of a transaction, which in the case of securitisation would be to provide financing to the originator, is of less importance in the characterisation of a transaction than the method by which the parties intend to reach that effect. This is a major benefit for securitisation in English law. Furthermore, there are policy considerations in favour of characterising the assignment as a sale, such as the importance of securitisation for the English economy.

The effect of non-assignment clauses in the underlying agreements of claims is not settled in English law and poses some risk to securitisation.<sup>268</sup> This means that the underlying agreements must be closely examined before the securitisation of those claims in order to decide whether the claims are available for use in the scheme.

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<sup>265</sup> See par 3.2.6.

<sup>266</sup> See par 3.3.2.2.

<sup>267</sup> See par 3.3.2.3.

<sup>268</sup> See par 3.3.2.4.

I considered the possible avoidance of the sale of the book debts by the originator to the SPV in terms of English insolvency law. I submit that the risk of avoidance is very small, except in the most extraordinary circumstances. An application by the liquidator to have the transaction set aside as a voidable preference will fail, because the SPV will usually not be a creditor of the originator before, or for that matter after, the securitisation transaction.<sup>269</sup>

The possibility that the liquidator will be able to convince a court that the securitisation transaction was at an undervalue, is in my opinion very small.<sup>270</sup> However, even if the liquidator is successful in proving that the transaction was at an undervalue, I believe that the defence in section 238(5) would be available to the SPV. In terms of this section, the court will not make an order if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and that at the time of the transaction there were reasonable grounds for believing that it would benefit the company. Bearing in mind the advantages of securitisation as discussed in Chapter 2, I believe that it will be easy to show that the securitisation could benefit the originator, even when it was in financial difficulty at the time of the transaction.

I further think that it is likely that a court will use its discretion in terms of section 238 not to make an order, even if all the requirements are met, when the transaction under consideration is securitisation. The investors in the securities of the SPV will have acted in good faith and are protected from any negative effects in terms of a section 238 order.<sup>271</sup>

I briefly considered some legislative provisions relevant to securitisation in English law. There are no legislative bars to securitisation in English law.

On the whole, English law provides a favourable legal environment for securitisation. The financing needs of companies might be better served by a sale of assets than by using those assets as security, especially when those assets are claims. Although an equitable assignment of book debts in English law without notice to debtors does carry some risk, as is evident in the next chapter on the position in the

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<sup>269</sup> See par 3.3.3.2.

<sup>270</sup> See par 3.3.3.1.

<sup>271</sup> Section 241.

United States, no legal system provides an entirely risk-free environment for securitisation.



## CHAPTER 4 AMERICAN LAW

### 4.1 INTRODUCTION

Originally, the English common law was the law of the colonies that eventually formed the United States of America.<sup>1</sup> However, the social and commercial environment of the New World differed a great deal from that in England. This led to the evolution of a legal system that today differs substantially from English law. These differences are further shaped by the fact that the American law serves a dual system of government, whereas the English law serves a unitary system of government.<sup>2</sup>

The interplay between the federal law and the law of the 50 states requires a practitioner to determine which law will govern a particular transaction. The Federal Constitution grants the federal government only those powers that have been expressly conveyed to it by the states.<sup>3</sup> As a result, state law governs most of the day-to-day legal matters.<sup>4</sup>

There are three additional factors that influence the decision whether to apply federal or state law:<sup>5</sup>

- 1 Even though a state may retain jurisdiction over a particular field of law, its legislative and administrative declarations must not conflict with the broad, underlying Federal Constitutional principles and legislative declarations that relate to those matters.
- 2 States may legislate on matters that fall within the normal jurisdiction of the federal government, as long as the resulting legislation does no more than supplement or complement the federal legislation.

<sup>1</sup> In *Calvin's Case* (1608), 7 Co. I., 17b, 77 E.R. 397 it was held that in principle the common law of England would apply in the colonies, but only as far as adapted to local institutions and circumstances. See further Dennis Campbell & Winifred Hepperle *The US Legal System: A Practice Handbook* (1983) at 2–3.

<sup>2</sup> Campbell & Hepperle *US Legal System* at 3.

<sup>3</sup> The Tenth Amendment to the United States Constitution, enacted in 1791, declares: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively or to the people.”

<sup>4</sup> Campbell & Hepperle *US Legal System* at 5 and 51.

<sup>5</sup> Campbell & Hepperle *US Legal System* at 5–6.

- 3 In certain circumstances the federal courts may apply state laws to resolve a legal matter.<sup>6</sup>

The United States Supreme Court held in *Erie Railroad Co v Tompkins*<sup>7</sup> that there is no such thing as a federal or national ‘common law’ in the United States of America. That notwithstanding, there is cohesion in the laws of the different states and judges often cite, and rely on, decisions from other states in their decisions. The National Conference of Commissioners on Uniform State Laws was established to further such cohesion. This organisation drafts uniform laws. States elect whether to adopt the uniform law and they often modify the law to shape their own point of view.

Apart from deciding whether a legal matter falls under the jurisdiction of the federal or the state law, legal practitioners must also decide which state law will govern a legal matter. To this end, a sophisticated body of conflict of laws rules has developed.<sup>8</sup>

The federal court system is organised in three tiers.<sup>9</sup> At the lowest or trial level is the United States District Courts, to which a geographical jurisdiction is assigned. On the next tier is the United States Courts of Appeal, which are empowered to review all decisions of the District Courts, unless the law provides for direct access to the Supreme Court. The Courts of Appeal are organised in 11 geographical Circuits. The court of last resort in the federal system is the United States Supreme Court. Appeal to the Supreme Court is usually not a matter of right, but the court has discretion to select those matters it wants to hear.

There is great variation between the court systems of the various states.<sup>10</sup> Most states have followed the three-tier system preferred at federal level, but some have opted for a four-tier system and a few have systems even less structured.

#### **4.1.1 Securitisation in United States of America**

Securitisation<sup>11</sup> as a financing method has its origin in the United States of America.<sup>12</sup> During the Great Depression the housing credit market collapsed and Congress passed

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<sup>6</sup> See the Federal Judiciary Act of 1789.

<sup>7</sup> 304 US 64 (1938).

<sup>8</sup> Campbell & Hepperle *US Legal System* at 6–7.

<sup>9</sup> Campbell & Hepperle *US Legal System* at 52–53.

<sup>10</sup> Campbell & Hepperle *US Legal System* at 53–55.

the National Housing Act 1934 to create a secondary market in mortgages. The Federal National Mortgage Association was established in 1938 as a result of this legislation to provide liquidity to mortgage markets by purchasing mortgages when funds were low and selling when funds were adequate. The association is generally known as ‘Fannie Mae’. In 1970 two further mortgage associations were established, namely the Government National Mortgage Association (‘Ginnie Mae’) through a privatisation of part of Fannie Mae and the Federal Home Loan Mortgage Corporation (‘Freddie Mac’). Also in 1970 these associations started to trade mortgage-backed securities to the public.<sup>13</sup>

The mortgage associations are sometimes referred to as ‘government-sponsored enterprises’. Despite the suggestion created by the term, only Ginnie Mae is backed by government guarantees. The term probably originated from the fact that these corporations were created by the United States Congress in order to enhance the flow of credit to targeted sectors of the economy.<sup>14</sup> However, the capital markets regard Fannie Mae and Freddie Mac as virtually guaranteed by the United States Government, because Congress will probably not allow them to collapse.<sup>15</sup>

Government-sponsored enterprises only accept mortgages from borrowers with good credit histories. The mortgages bought by Fannie Mae and Freddie Mac are fairly homogeneous in terms of their maturity and interest rates. The government-sponsored entities further require standardised documentation to be used in the mortgages they buy.

Mortgages that do not qualify to be securitised through one of the government-sponsored enterprises are also securitised, but at greater risk to the investor. It is this

<sup>11</sup> American sources refer to ‘securitization’, but to be consistent I maintain the spelling used in English sources.

<sup>12</sup> Joseph Jude Norton & Paul R Spellman *Asset Securitization: International Financial and Legal Perspectives* (1991) at 19; Norton *et al Asset Securitization* at 3.

<sup>13</sup> For a detailed account of the development of the securitisation market in the USA, see Christopher L Peterson “Predatory Structured Finance” (2007) 28 *Cardozo LR* at 2191–2206.

<sup>14</sup> The other two sectors targeted by similar vehicles are agriculture and education.

<sup>15</sup> See Christopher L Peterson “Over-Indebtedness, Predatory Lending, and the International Political Economy of Residential Home Mortgage Securitization: A Comparative Analysis of the U.S. Subprime Home Mortgage Lending Crisis” in William Whitford, Ian DC Ramsay & Johanna Niemi *Consumer Credit, Debt and Bankruptcy: National and International Perspectives* (forthcoming 2009). This was finally proven on 7 September 2008 when the US Federal Reserve took over Fannie Mae and Freddie Mac to fend off the effects of the credit crisis.

sector of the mortgage market that has come to be known as the ‘sub-prime’ sector<sup>16</sup> and which has come under considerable strain in recent times. The pressure experienced by the mortgage market in this sector is due to a number of factors, among which is a downturn in the housing market<sup>17</sup> and poor consumer practices in general.<sup>18</sup> In this discussion I shall only deal with how securitisation could have contributed to the scale of the problem.

The securitisation market in the United States of America is known for its innovation and vitality. Today almost any asset of a company can be securitised.<sup>19</sup>

In this chapter I provide an overview of the system that creates security interests over property in the United States of America. I then review specific legal considerations surrounding securitisation. The general form and function of a securitisation scheme are set out in Chapter 2.

## **4.2 REVISED ARTICLE 9 OF UNIFORM COMMERCIAL CODE**

The Uniform Commercial Code is a collection of recommended laws first issued by the National Conference of Commissioners on Uniform State Laws in 1951, which deals with legal issues that may arise during commercial dealings. The Code consists of 11 articles that have been revised from time to time.<sup>20</sup> All the states have enacted the Code, except Louisiana, which enacted only certain parts of it. However, not all

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<sup>16</sup> See Peterson 2007 *Cardozo LR* at 2199–2206 for a discussion of the development of the sub-prime securitisation market.

<sup>17</sup> The sales figures of new houses in the United States dropped by 26,4 per cent in 2007, which represents the largest decline in house sales ever recorded in that country. Sales of existing homes dropped by 13 per cent and the construction of new housing fell by 24,9 per cent. This downturn is a continuation of a pattern that started in 2006 and it is predicted to worsen as 2008 progresses. The average sales price of a house fell by 10, 4 per cent in December 2007. See Associated Press “New Home Sales Fell by Record Amount in 2007: Sale Prices Posted Weakest Showing in 16 Years” 29 January 2008, available at [www.msnbc.msn.com/id/22880294/](http://www.msnbc.msn.com/id/22880294/) (accessed 14 May 2008).

<sup>18</sup> The sector of the community that does not qualify for good interest rates is often also that sector that does not have the benefit of a good education or sound financial advice. This leaves these consumers vulnerable to predatory lending practices. For a more detailed discussion of these predatory lending practices, see Peterson 2007 *Cardozo LR* at 2213–2215.

<sup>19</sup> Norton *et al Asset Securitization* at 5–7.

<sup>20</sup> Article 1: General Provisions, Article 2: Sales, Article 3: Commercial Paper, Article 4: Bank Deposits and Collections, Article 5: Letters of Credit, Article 6: Bulk Transfers, Article 7: Warehouse Receipts, Bills of Lading and Other Documents of Title, Article 8: Investment Securities, Article 9: Secured Transactions; Sales of Accounts and Chattel Paper, Article 10: Effective Date and Repealer, Article 11: Effective Date and Transition Provisions.

states have enacted the Code without amendment, which means that some discrepancies remain between the different states in their commercial laws.<sup>21</sup>

The Permanent Editorial Board for the Uniform Commercial Code with the support of its sponsors, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, formed a committee in 1990 to study the possible revision of Article 9 of the Uniform Commercial Code.<sup>22</sup> The revision process was completed in 1998. Revised Article 9 became effective in all the states on 1 July 2001.<sup>23</sup> All references in this discussion are to the revised Article 9, unless specifically indicated otherwise.

Article 9 is the most important article in the Uniform Commercial Code for securitisation.<sup>24</sup> It addresses both the creation of security interests and the sale of certain kinds of property. The distinction between the creation of a security interest and a sale of the property, as well as the classification of a transaction as one or the other is very important for securitisation.<sup>25</sup>

The sale of the assets to the SPV must be in the form of a true sale before a rating agency will assign a rating to the securities issued by the SPV. To this end, they require legal opinions that the sale is a true sale and that the originator is bankruptcy-remote from the SPV.<sup>26</sup> Although Article 9 makes it clear that a sale of accounts will leave no legal or equitable interest in the estate of the seller,<sup>27</sup> it does not describe under what circumstances a transaction will be considered a sale. This is seen by McCormack as a major flaw in the Article 9 system.<sup>28</sup>

Section 9-109 sets out the transactions to which Article 9 applies. For purposes of this thesis it is important to note that Article 9 applies to a transaction, regardless of its form, that creates a security interest in personal property by contract,<sup>29</sup> as well as to

<sup>21</sup> Campbell & Hepperle *US Legal System* at 239.

<sup>22</sup> See the Official Comment on § 9-101 for a full account of the history of revised Article 9.

<sup>23</sup> § 9-701.

<sup>24</sup> Dolan & Davis *Securitized* at 5-3.

<sup>25</sup> Dolan & Davis *Securitized* at 5-14; McCormack *Secured Credit* at 237–238.

<sup>26</sup> See the discussion of Lupica 1998 *Texas LR* at 641–642.

<sup>27</sup> § 318(a).

<sup>28</sup> McCormack *Secured Credit* at 245–246.

<sup>29</sup> § 9-109(a)(1).

a sale of accounts, chattel paper, payment intangibles, or promissory notes.<sup>30</sup> ‘Accounts’, ‘chattel paper’ and ‘payment intangibles’ are defined extensively in section 9-102.<sup>31</sup> ‘Account’ means a right to payment of a monetary obligation, whether or not earned by performance, that arose from one of the following transactions:<sup>32</sup>

- Property that has been sold, leased, licensed, assigned, or otherwise disposed of.
- Services rendered or to be rendered.
- An insurance policy issued or to be issued, including health care insurance receivables.
- A secondary obligation incurred or to be incurred.
- Energy provided or to be provided.
- The use or hire of a vessel under a charter or other contract.
- Credit card transactions.
- The winnings in a lottery or other game of chance sponsored or authorised by the State.

Most of those assets generally transferred to an SPV during a securitisation transaction will be an account in terms of this definition.<sup>33</sup>

‘Chattel paper’ is defined as a record that evidences a monetary obligation coupled with a security interest in specific goods, or a security interest in specific goods and software used in the goods, or a security interest in specific goods and a licence of software used in the goods, or a lease of specific goods, or a lease of specific goods and a licence of software used in the leased goods.<sup>34</sup>

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<sup>30</sup> § 9-109(a)(3). A sale of these asset types for collection purposes only, such as in the case of a factoring agreement, is specifically excluded from the scope of article 9 in § 9-109(d)(5).

<sup>31</sup> This individualisation and categorisation of collateral in Article 9 is criticised by McCormack *Secured Credit* at 246–247 as unnecessarily complicated.

<sup>32</sup> § 9-102(a)(2).

<sup>33</sup> The previous definition of ‘account’ read: “any right to payment for goods sold or leased or for services rendered, which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance” (UCC § 9-106 (1995)). There was uncertainty whether assets such as credit card receivables and the proceeds from intellectual property licensing agreements would be ‘accounts’ under this definition. This uncertainty has now been removed. See Lois R Lupica “Revised Article 9, the Proposed Bankruptcy Code Amendments and Securitizing Debtors and their Creditors” (2002) 7 *Fordham J of Corporate & Financial Law* at 329 and 333.

<sup>34</sup> § 9-102(a)(11). See also McCormack *Secured Credit* at 239–240.

A payment intangible is a general intangible in terms of which the account debtor's principal obligation is a monetary obligation. The practical effect of this definition is that a payment intangible is considered a general intangible for purposes of the creation of security interests, but as a category on its own when the sale of those assets are at issue.<sup>35</sup> Before Article 9 was revised in 1998, such intangibles fell outside the scope of Article 9 when sold during a securitisation transaction, which meant that the purchase went unperfected<sup>36</sup> and left the buyer vulnerable to rights acquired by subsequent transferees.<sup>37</sup>

The revised Article 9 also extended the definition of 'proceeds', with significant implications for securitisations. Assets that are acquired by the bankruptcy debtor after the filing of the bankruptcy petition fall outside the reach of secured parties, unless these assets are proceeds of the original collateral.<sup>38</sup> The revised section 9-102(a)(64) defines 'proceeds' as "whatever is acquired upon the sale, lease, licence, exchange, or other disposition of collateral; whatever is collected on, or distributed on account of, collateral and; rights arising out of collateral". More assets will therefore in future be considered "proceeds" under this definition and will fall outside the scope of the bankrupt estate of the originator.<sup>39</sup>

Most asset types ordinarily transferred during a securitisation transaction will fall under one of these definitions. Consequently, the purchase of the assets by the SPV from the originator will have to comply with the requirements of Article 9.<sup>40</sup>

#### 4.2.1 Security interests in property

Article 9 does not classify types of security as mortgages, charges or pledges as is the case in English and South African law, but uses the generic term 'security interests' to denote all forms of security. It also makes no distinction between legal and equitable

<sup>35</sup> Dolan & Davis *Securitized* at 5-8.

<sup>36</sup> See par 4.2.1 for a definition of perfection.

<sup>37</sup> Dolan & Davis *Securitized* at 5-13.

<sup>38</sup> 11 USC §§ 552(a) and 552(b)(1). § 9-102(a)(12) UCC defines 'collateral' as "the property subject to a security interest or agricultural lien. The term includes: (A) proceeds to which a security interest attaches; (B) accounts, chattel paper, payment intangibles, and promissory notes that have been sold; and (C) goods that are the subject of a consignment."

<sup>39</sup> See also Lupica 2002 *Fordham J of Corporate & Financial Law* at 340.

<sup>40</sup> On these amendments of Article 9 generally, see Lois R Lupica "Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization" (2000) 33 *Connecticut LR* at 218-219.

security interests or between fixed and floating security interests.<sup>41</sup> ‘Security interest’ is defined in section 1-201(35) of the Uniform Commercial Code as an interest in personal property or fixtures that secures either payment or else the performance of an obligation.

The concepts of ‘attachment’ and ‘perfection’ are central to a proper understanding of the functioning of Article 9. A security interest *attaches* when it becomes enforceable between the debtor and the creditor.<sup>42</sup> A security interest becomes *perfected* when it becomes effective against third parties.

#### 4.2.1.1 Attachment of security interest

A security interest is only enforceable against a debtor if<sup>43</sup>

- value has been given; and
- the debtor has rights in the collateral or the entitlement to transfer rights in the collateral to a secured party.

In addition, one of a possible four conditions must be met before attachment will follow.<sup>44</sup> The condition most often met is that the debtor has authenticated<sup>45</sup> a security agreement that provides a description of the collateral.<sup>46</sup> A ‘description’ is defined as sufficient if it reasonably identifies what is described.<sup>47</sup> A description of the collateral as “all the debtor’s assets” or “all the debtor’s personal property” does not reasonably identify the collateral,<sup>48</sup> but a category of collateral will qualify as a sufficient description,<sup>49</sup> for example “the stock-in-trade of the debtor”.

The other three conditions that can be fulfilled in order to lead to attachment are as follows:

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<sup>41</sup> McCormack *Secured Credit* at 71. For the position in English law, see par 3.1 and for the position in South African law, see par 5.4.

<sup>42</sup> § 9-202(a). See also McCormack *Secured Credit* at 73.

<sup>43</sup> § 9-203(b)(1) and (2).

<sup>44</sup> § 9-203(b)(3).

<sup>45</sup> According to §9-102(a)(7) ‘authenticate’ means: “(A) to sign; or (B) to execute or otherwise adopt a symbol, or encrypt or similarly process a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.”

<sup>46</sup> See n 38 for the definition of ‘collateral’.

<sup>47</sup> § 9-108(a).

<sup>48</sup> § 9-108(c).

<sup>49</sup> § 9-108(b)(2).



- 1 The secured party is in possession of the collateral pursuant to the debtor's security agreement and the collateral is not a certificated security.<sup>50</sup>
- 2 The collateral is a certificated security in registered form and has been delivered to the secured party in terms of the debtor's security agreement.<sup>51</sup>
- 3 The secured party has control of the collateral as described in the relevant sections of Article 9.<sup>52</sup> The collateral in this case will be deposit accounts,<sup>53</sup> electronic chattel paper, investment property,<sup>54</sup> letter-of-credit rights<sup>55</sup> or electronic documents.

Although Article 9 does not specifically mention a floating charge, it specifically allows a security interest over the collateral where the debtor remains entitled to deal freely with the collateral. Section 9-205 provides that a security interest is not invalid or fraudulent against creditors because the debtor has the right or ability to

- use, commingle, or dispose of all or part of the collateral, including returned or repossessed goods;
- collect, compromise, enforce or otherwise deal with the collateral;
- accept the return of the collateral or make repossessions;
- use, commingle or dispose of proceeds; or
- because the secured party fails to require the debtor to account for proceeds or to replace the collateral.<sup>56</sup>

A security agreement may create a security interest in an after-acquired collateral, but such a security interest will only attach when the debtor "has rights in the collateral".<sup>57</sup>

<sup>50</sup> § 9-203(b)(3)(B).

<sup>51</sup> § 9-203(b)(3)(C).

<sup>52</sup> § 9-203(b)(3)(D).

<sup>53</sup> See n 75 on how control over deposit accounts can be obtained.

<sup>54</sup> See n 74 on how control over investment property can be obtained.

<sup>55</sup> See n 76 on how control over letter-of-credit rights can be obtained.

<sup>56</sup> See McCormack *Secured Credit* at 73–75 for the history of this provision.

<sup>57</sup> § 9-204(a). If the after-acquired collateral clause relates to consumer goods or to a commercial tort claim, the security interest will not attach. See § 9-204(b).

#### 4.2.1.2 Perfection of security interest

Section 9-308(a) provides that a security interest is perfected when it has attached, and when all steps required for perfection under any provision of the Article have been complied with. Perfection of a security interest in a right to payment also perfects a security interest in a security interest, mortgage or other lien over personal or real property securing the right.<sup>58</sup> In other words, when a security interest in a loan secured by a mortgage is perfected, the security interest in the mortgage is perfected simultaneously.

The usual method of obtaining perfection of a security interest is by way of filing, and the date of filing is used to determine priorities between the security interests of competing parties to the same collateral.<sup>59</sup>

##### 4.2.1.2.1 Notice filing

Notice filing must be distinguished from the registration requirement of English law. Under the English system of registration certain particulars of a charge must be filed with the Registrar of Companies, together with the security agreement, within 21 days after the creation of the charge. When satisfied that the filed particulars and the security agreement correspond, the Registrar issues a certificate, which is conclusive evidence that all registration requirements have been complied with.<sup>60</sup>

Under a notice filing system the security agreement is not filed, but only a simple record known as a 'financing statement'. The financing statement is usually filed by the secured party.<sup>61</sup> The financing statement contains only a limited amount of information and may be filed before or after attachment. The statement indicates that the person may or may not have a security interest in the collateral mentioned, and an interested party will then have to make his own further enquiries to ascertain the true position.<sup>62</sup> This means that the filing of one notice can cover the whole credit

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<sup>58</sup> § 9-308(e).

<sup>59</sup> McCormack *Secured Credit* at 76. See also Dolan & Davis *Securizations* at 5-20.

<sup>60</sup> See par 3.2.

<sup>61</sup> Under the previous version of Article 9 the debtor's signature was required on the financing statement (§ 9-402(1)). In the revised Article 9 the debtor's authorisation of a security agreement constitutes authorisation of the filing of a financing statement. The secured party is not required to obtain any further authorisation (§ 9-509(b)).

<sup>62</sup> In many cases the secured party will divulge such supplementary information freely. However, § 9-210 provides measures whereby a prospective creditor can require a possible secured party to

relationship between two parties, without the need for repeated filing as the collateral changes or when new advances are made, provided that the collateral is described broadly enough.<sup>63</sup> A filing statement is valid for a period of five years after the date of filing.<sup>64</sup>

A financing statement must contain the name of the debtor, the name of the secured party or of the representative of the secured party and indicate the collateral covered by the financing statement.<sup>65</sup> An indication that the financing statement covers all the assets of the debtor or all of his personal property will suffice for the financing statement, but not for a sufficient description of the collateral in the security agreement.<sup>66</sup> Such a description in the security agreement cannot lead to attachment of the security interest.<sup>67</sup>

The following are considered to be advantages of the notice filing system as compared to the registration of transactions:<sup>68</sup>

- It facilitates the use of stock-in-trade or claims (referred to as ‘receivables’ in American sources) as collateral, because there is no need to file repeatedly where there are numerous transactions between the parties.
- There is no need to file repeatedly when the collateral changes from day to day.
- A financing statement can cover a security agreement that was not yet in existence at the filing of the notice, even if it was not yet under consideration between the parties.<sup>69</sup> The only requirement is that the description of the collateral should be broad enough to cover the collateral eventually provided as security.
- A financing statement can include after-acquired assets as collateral and future advances to be secured without the need to mention these future transactions specifically.

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disclose whether and to what extent his claims against the debtor is secured. See also McCormack *Secured Credit* at 77.

<sup>63</sup> McCormack *Secured Credit* at 77.

<sup>64</sup> § 9-515(a).

<sup>65</sup> § 9-502(a). § 9-503 elaborates on the sufficient indication of the debtor.

<sup>66</sup> § 9-504(2). See also McCormack *Secured Credit* at 78.

<sup>67</sup> See par 4.2.1.1.

<sup>68</sup> McCormack *Secured Credit* at 77.

<sup>69</sup> § 9-502(d) allows this specifically.

#### 4.2.1.2.2 *Perfection without notice filing*

There are a few security interests where perfection is permissible by means other than notice filing. Certain security interests are perfected automatically on attachment, including:<sup>70</sup>

- An assignment of accounts or payment intangibles that does not itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles.
- A sale of payment intangibles.<sup>71</sup> However, when the sale of payment intangibles takes place in connection with a securitisation transaction, it will be safer to also file a financing statement.<sup>72</sup> Otherwise there is a risk that if a court recharacterises the transaction as a 'loan' rather than a 'sale', the security interest would not be perfected. Such filing further safeguards the position of the SPV should the originator attempt to sell the same claims more than once. In the absence of notice-filing, the priority in such a case would be determined by the date of first perfection. However, it may be very difficult to prove which party perfected first. Furthermore, since previous sales of payment intangibles might not have been filed, the securitisation of payment intangibles remains riskier, because it is less certain that there are no competing claims on the transferred assets.<sup>73</sup>

A security interest in investment property,<sup>74</sup> deposit accounts,<sup>75</sup> letter-of-credit rights<sup>76</sup> or electronic chattel paper<sup>77</sup> may be perfected through control of the collateral.<sup>78</sup>

<sup>70</sup> § 9-309.

<sup>71</sup> See par 4.2 for a definition of 'payment intangible'. The automatic perfection of payment intangibles was the result of pressure from financiers involved in loan participations. These financiers were satisfied with existing methods for the perfection of a sale of loans, namely that it would perfect immediately, and were concerned that notice filing would complicate their dealings. Initially it was recommended that the sale of payment intangibles between 'financial institutions' should be excluded from the general perfection requirements. However, it emerged that a uniform definition of 'financial institution' was just as difficult to come by. Consequently, it was decided that a sale of payment intangibles would be perfected automatically on attachment. See the discussion of Paul M Shupack "Making Revised Article 9 Safe for Securitizations: A Brief History" (1999) 73 *American Bankruptcy LJ* at 174–176; Steven L Schwarcz "The Impact on Securitization of Revised UCC Article 9" (1999) 74 *Chicago-Kent LR* at 955; Lupica 2000 *Connecticut LR* at 220.

<sup>72</sup> Shupack 1999 *American Bankruptcy LJ* at 179.

<sup>73</sup> Schwarcz 1999 *Chicago-Kent LR* at 955.

<sup>74</sup> 'Investment property' is defined in § 9-102(a)(49) as "a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account." Although perfection of investment property can also follow on notice filing, perfection by way of control confers priority on the person who controls. Certificated securities can either be in bearer form or in registered form. Security interests in certificated securities in bearer form are perfected by

#### 4.2.1.3 Priorities among conflicting security interests

The general principle is that the first party to file a financing statement has priority over other secured parties with security interests in the same collateral.<sup>79</sup> This priority will follow, regardless of the time that the security agreement actually came into being.<sup>80</sup> A perfected security interest has priority over an unperfected security interest.<sup>81</sup> If all the security interests are unperfected, the security interest that attached first will enjoy priority.<sup>82</sup>

Priority for security interests in deposit accounts and in letter-of-credit rights is determined by who is in control.<sup>83</sup> Security interests in investment property can follow through notice filing, but the secured party who gains control over the investment property will enjoy priority.<sup>84</sup>

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control when a person takes delivery of the certificate (UCC § 8-106(a)). To take control of a certificated security in registered form, the secured party must take delivery of the certificate and either have it indorsed to him in blank by an effective endorsement or have the issuer register it in his name (UCC § 8-106(b)). Control over an uncertificated security is established either by delivery, or by an agreement that the issuer of the security will comply with the secured party's instructions without further consent by the debtor (UCC § 8-106(c)). Investment property as defined can be a securitised asset type (see par 2.4), which makes these provisions important for our discussion.

<sup>75</sup> A deposit account is a bank account. Security taken over the account where the servicer deposits its collected payments is important in the event of the servicer's bankruptcy. The only method to perfect a security interest in a deposit account under Article 9 is by control (§ 9-312(b)(1)). If the party attempting to perfect its security interest is the bank where the account is held, it has control (§ 9-104(a)(1)). Otherwise the secured party will gain control over the account when the debtor, the secured party and the bank have agreed in an authenticated record that the bank will comply with the instructions of the secured party without further consent of the debtor (§ 9-104(a)(2)), or when the secured party becomes the customer of the bank with respect to the deposit account (§ 9-104(a)(3)). Neither the section nor the Official Comment sheds any light on how this latter possibility will come about, but I assume it will be through a novation of the bank's agreement with the debtor. Perfection will only remain while the secured party retains control over the deposit account (§ 9-314(b)).

<sup>76</sup> Letter-of-credit rights are often a credit enhancement method during a securitisation scheme and will form part of the security in favour of the investors in the securities issued by the SPV. Perfection of security interests in letter-of-credit rights can only be effected by control (§ 9-312(b)(2)). A secured party has control of a letter-of-credit right to the extent of any right it has to payment or performance by the issuer if the issuer has consented to an assignment of the proceeds of the letter-of-credit under § 5-114(c) or otherwise applicable law or practice (§ 9-107). The secured party must retain control over the deposit account (§ 9-314(b)).

<sup>77</sup> For the control provisions of electronic chattel paper, see § 9-105.

<sup>78</sup> § 9-314(a).

<sup>79</sup> § 9-322(a)(1).

<sup>80</sup> McCormack *Secured Credit* at 80–81.

<sup>81</sup> § 9-322(a)(2).

<sup>82</sup> § 9-322(a)(3).

<sup>83</sup> See n 75 and 76. See also Dolan & Davis *Securitizations* at 5-26 to 5-28.

<sup>84</sup> See n 74; Dolan & Davis *Securitizations* at 5-28 to 5-29.

Knowledge of a prior unperfected security interest will not deprive a perfected security interest holder of his priority. Article 9 does not make good faith a requirement for priority.<sup>85</sup>

A secured party may agree that his claim be subordinated to that of another secured party, even if he would normally have priority. Subordination agreements are specifically provided for in section 9-339.

Generally, a purchase money security interest will have priority over an earlier perfected security interest in the same collateral.<sup>86</sup> However, if the purchase money security interest is in inventory,<sup>87</sup> this priority will not extend to the proceeds of the inventory after it has been sold. The proceeds may be sold without being subject to the security interest of the purchase money financier.<sup>88</sup> This benefits securitisation, where the assets sold might be claims that result from the sale of inventory.

#### 4.2.2 Sale of accounts, chattel paper, payment intangibles and promissory notes

The usual method by which assets are transferred to the SPV is by assignment. Novation is seldom used, because the debtor's consent is necessary for a valid novation and originators do not want their clients to know that they have securitised the claims. Furthermore, novation terminates any security interest that attached to the original agreement. Since the original agreement is terminated by novation, the security for the claims resulting from that contract is also terminated. This has the practical effect that the newly agreed security interest must be filed, which has an effect on the priority of the security and will mean that the avoidance periods will start to run afresh.<sup>89</sup>

<sup>85</sup> McCormack *Secured Credit* at 155–158; *Re Smith* (1971) 326 F Supp 1311 at 1314: “the drafters of the code were aware of and intended that knowledge be irrelevant in determining priorities under that section.”

<sup>86</sup> § 9-324(a). A ‘purchase money security interest’ is a security interest held by a financier who advanced money so that a person could purchase a specific asset. The financier then takes a security interest in the asset purchased.

<sup>87</sup> For the definition of ‘inventory’, see § 9-102(a)(48).

<sup>88</sup> See the Official Comment to § 9-324; Schwarcz 1999 *Chicago-Kent LR* at 956.

<sup>89</sup> Albrecht & Smith 1998 *Duke J of Comp & Int L* at 432–440. It is possible for the SPV to take up a participation in the pool of claims securitised, but this will probably not constitute a true sale of the claims but only a transfer of some of the risk associated with the outstanding claims. It is likely that such a transaction will be characterised as a synthetic securitisation rather than a traditional securitisation, and this aspect falls outside the scope of this thesis. See Albrecht & Smith 1998 *Duke J of Comp & Int L* at 444–447.

Before the revision of Article 9 in 1998 there was some uncertainty as to the effects of a sale of property that falls under the Article. More particularly, some authors argued that such sales had to be recharacterised as security interests rather than true sales, which would have meant that the property remained in the estate of the seller and was vulnerable in the event of the seller's bankruptcy.<sup>90</sup> Such an interpretation was especially prevalent after the decision in *Octagon Gas Systems, Inc v Rimmer*<sup>91</sup> where the Court held that the sale transactions covered by Article 9 created a situation where the buyer became a secured party who acquired a security interest in the purchased asset and the seller was the debtor.<sup>92</sup>

The Uniform Commercial Code's Permanent Editorial Board issued a draft commentary on the decision to disapprove of the reasoning followed in *Octagon Gas Systems*.<sup>93</sup> According to the commentary, the purpose of including sale of accounts under the provisions of Article 9 was to recognise the similarity that such transactions show with secured transactions and to provide notice to third parties.<sup>94</sup> However, it was not the intention to change the nature or the effect of the transaction from a sale to a secured loan.

Revised section 9-318(a) now provides that a debtor who has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold. This means that the purchased accounts will not form part of the debtor's estate during his bankruptcy, and removes the uncertainty that existed previously in this regard. This amendment is beneficial to securitisation, where the sale of accounts by an originator to an SPV makes up an integral part of transactions. However, the applicability of the section is dependent on

<sup>90</sup> Article 9 refers to 'debtor' throughout, also when it sets out the provisions relating to sale of accounts, chattel paper, payment intangibles and promissory notes. I shall refer to 'seller' in the discussion of sale.

<sup>91</sup> 995 F 2d 948, 945–955 (10<sup>th</sup> Cir). See also Lupica 1998 *Texas LR* at 655–657; Lupica 2002 *Fordham J of Corporate & Financial Law* at 332–333.

<sup>92</sup> At 955.

<sup>93</sup> UCC Permanent Editorial Board *Commentary on the Uniform Commercial Code, Commentary No 14 (Section 9-102(1)(b))* (10 June, 1994).

<sup>94</sup> See Dolan & Davis *Securitized* at 5-16.

a finding that the transaction is a sale of accounts, rather than the use of the accounts as security, which leaves the characterisation of the transaction as important as ever.<sup>95</sup>

An account debtor<sup>96</sup> on an account, chattel paper or payment intangible may continue to discharge his obligations by paying the assignor, until the account debtor receives notice that the claim has been assigned and that payment must now be made to the assignee.<sup>97</sup> After receiving such notice, the account debtor may only discharge his obligation by payment to the assignee. Such notification will not be effective if it does not reasonably identify the rights assigned, if an agreement between the debtor and the assignor limited the account debtor's duty to pay a person other than the assignor, or if the notification notifies the account debtor to make a payment to the assignee that is less than the full amount payable in terms of an instalment or periodic payment.<sup>98</sup> Unless the account debtor has entered into an enforceable agreement not to make use of defences or claims, the assignee takes the account subject to any defence or claim that the account debtor may have had against the assignor before the account debtor received notice of the assignment.<sup>99</sup>

Article 9 aims to limit restrictions on the assignment of claims by providing that contractual terms restricting the assignment of interests in accounts,<sup>100</sup> chattel paper, payment intangibles or promissory notes are ineffective. Contractual terms that provide that such assignment will lead to a default, breach, claim, defence, or termination, among other remedies listed, will also be ineffective.<sup>101</sup> However, with respect to payment intangibles, promissory notes and health care insurance receivables, assignment in contravention of such restrictions will not be enforceable

<sup>95</sup> See also the comments of Shupack 1999 *American Bankruptcy LJ* at 179 and 180; Lupica 2002 *Fordham J of Corporate & Financial Law* at 337. See par 4.3.2.1 for a discussion of the possibility of recharacterisation.

<sup>96</sup> An 'account debtor' is defined as "a person obligated on an account, chattel paper, or general intangible." The term does not include persons obligated to pay a negotiable instrument, even if the instrument constitutes part of chattel paper (§ 9-102(a)(3)).

<sup>97</sup> § 9-406(a). See also McCormack *Secured Credit* at 233–234. Usually the debtor will not receive notification of the assignment of the claim in securitisation. Since the originator often continues to act as servicer of the claims on behalf of the SPV, the identity of the person whom the debtor must pay does not change. If the originator does not act as servicer these aspects become more important.

<sup>98</sup> § 9-406(b).

<sup>99</sup> § 9-404(a)(2). See also McCormack *Secured Credit* at 235.

<sup>100</sup> Referred to as non-assignment clauses in English law (see par 3.2.2.4) and *pacta de non cedendo* in South African law (see par 6.2.4 n 84).

<sup>101</sup> § 9-406(d). See further McCormack *Secured Credit* at 229–230; Lupica 2000 *Connecticut LR* at 221–223.



against the debtor or the person obliged in terms of the promissory note, nor impose any duty on such a debtor or person, nor require the debtor or such a person to recognise the security interest or make payment to the assignee. Furthermore, such an assignee will not be entitled to enforce the security interest.<sup>102</sup>

### 4.3 SECURITISATION: SPECIFIC CONSIDERATIONS

#### 4.3.1 Regulatory considerations

Apart from the provisions of Article 9 of the Uniform Commercial Code discussed above, various statutes have an important impact on securitisation transactions in the United States of America. They are discussed below. I discuss selected provisions of the Bankruptcy Code separately in paragraph 4.3.2.

##### 4.3.1.1 Investment Company Act of 1940

In terms of the Investment Company Act of 1940<sup>103</sup> an issuer primarily engaged in the business of investing, reinvesting, owning, holding or trading in securities must register with the Securities and Exchange Commission (SEC) as an investment company.<sup>104</sup> The Act was intended to regulate mutual funds, investment funds and other investment vehicles.

‘Security’ is defined broadly and includes notes, stocks, bonds, debentures, securities futures, evidence of indebtedness, or any interest or instrument commonly known as a ‘security’.<sup>105</sup> Most claims<sup>106</sup> will fall under this definition, because they are evidence of indebtedness.<sup>107</sup>

The Act is a comprehensive regulatory scheme and compliance with its provisions is burdensome and costly.<sup>108</sup> For these reasons registration of an SPV as an investment

<sup>102</sup> § 9-408(a) and (d). See also Dolan & Davis *Securitized* at 5-30 to 5-31. This exception was included especially to satisfy the needs of financiers involved in loan participations. Loan participation agreements often include restrictions on the transferability of the loan, to ensure that only eligible institutions join the loan syndication. See Shupack 1999 *American Bankruptcy LJ* at 176–178; Schwarcz 1999 *Chicago-Kent LR* at 959–960.

<sup>103</sup> 15 USC § 80a *et seq.*

<sup>104</sup> § 80a-3.

<sup>105</sup> § 80a-2(a)(36).

<sup>106</sup> Claims are mostly referred to in American literature as ‘receivables’.

<sup>107</sup> Norton & Spellman *Legal Perspectives* at 34; Dolan & Davis *Securitized* at 3-32.

<sup>108</sup> Norton & Spellman *Legal Perspectives* at 34 and 96; Dolan & Davis *Securitized* at 3-32.

company is usually considered economically unfeasible. Transactions are structured so that one or more of the exemptions from registration under the Act would apply.

The SPV could make use of the exemption under section 3(c)(5)(A), which excludes from the definition of ‘investment company’ a person who is primarily engaged in purchasing or acquiring “open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services”. The securitisation of consumer credit and trade receivables will fall under this exemption,<sup>109</sup> because these claims will mostly reflect the purchase price of goods or services.

If a particular securitisation does not clearly fall under this exemption, the SPV could try to obtain a no-action letter from the SEC. A no-action letter is a non-binding response by the SEC staff to a private enquiry indicating that the staff of the SEC will not recommend enforcement action if a proposed transaction is carried out in a particular manner.<sup>110</sup>

Another possible way to avoid registration under the Act is to make use of the exemption given to issuers whose outstanding securities do not have more than 100 beneficial owners and who are not making a public offering of their securities.<sup>111</sup> This is often used together with the disclosure exemptions for private offerings contained in the Securities Act of 1933.<sup>112</sup> The securities in the SPV are then placed with a limited number of institutional and other investors.<sup>113</sup>

However, before the adoption of Rule 3a-7,<sup>114</sup> a particular securitisation scheme could still fall outside any of these exemptions. As a last resort the SPV could still have applied to the SEC for an order exempting it from registration. There are two possible grounds for such an application, namely that the SPV is primarily engaged in

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<sup>109</sup> See par 6.4.

<sup>110</sup> Norton & Spellman *Legal Perspectives* at 48.

<sup>111</sup> § 80a-3(c)(1). ‘Beneficial ownership’ if the investor is a company means one person, unless the company acquires more than ten per cent of the voting securities in the issuer. In the latter case the holders of the securities in the company will count as the beneficial owners (§ 80a-3(c)(1)(A)). The company will, however, still count as one person if its total investment in all the companies that fall under this exemption, or would have fallen under the exemption were it not for the beneficial owner rule, does not amount to more than ten per cent of its total assets. See also Norton & Spellman *Legal Perspectives* at 48.

<sup>112</sup> See below.

<sup>113</sup> Norton & Spellman *Legal Perspectives* at 35.

<sup>114</sup> 17 CFR § 270. 3a-7. See below.

a business other than that of investing, owning or trading in securities<sup>115</sup> or that an exemption is necessary or appropriate in the public interest and is consistent with the protection of investors and the policy and purposes of the Act.<sup>116</sup> It may take a long time for such an exemption to be given and there are no guarantees that the application will be successful. It is also possible that the SEC will grant the exemption conditionally, which may cause further expense and delay.<sup>117</sup>

However, since the adoption of Investment Company Act Rule 3a-7, it will seldom be necessary to obtain exemption from compliance with the Act. The Rule was adopted specifically to exempt asset-backed securities transactions from complying with the Act.<sup>118</sup>

Rule 3a-7 excludes from the definition of ‘investment company’ any issuer who

- is engaged in the business of purchasing or otherwise acquiring, and holding eligible assets<sup>119</sup> and certain related activities;
- does not issue redeemable securities;
- complies with the provisions of the Rule that require segregation of the underlying assets and restricts the ability of the issuer to acquire or dispose of the underlying assets; and
- offers certain types of asset-backed securities, namely non-investment grade securities and residual interests, only to sophisticated investors.

The SPV must issue fixed-income securities<sup>120</sup> or other securities, which entitle their holders to receive payments that depend primarily on the cash flow from eligible

<sup>115</sup> § 80a-3(b)(2).

<sup>116</sup> § 80a6(c).

<sup>117</sup> Norton & Spellman *Legal Perspectives* at 35 and 99.

<sup>118</sup> Dolan & Davis *Securitizations* at 3-33. See also Gambro & McCormack *Global Securitisation and Structured Finance* at 2.

<sup>119</sup> ‘Eligible assets’ is defined as “financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders” (Rule 3a-7(b)(1)).

<sup>120</sup> ‘Fixed income securities’ is defined as “any securities that entitle the holder to receive: (i) A stated principal amount; or (ii) Interest on a principal amount (which may be a notional principal amount) calculated with reference to a fixed rate or to a standard or formula which does not refer to any change in the market value or fair value of eligible assets; or (iii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to auctions among holders and prospective holders, or through remarketing of the security; or (iv) An amount equal to specified fixed or variable portions of the interest received on the assets held by the issuer; or (v) Any combination of amounts described in paragraphs (b)(2)(i), (ii), (iii), and (iv) of this section;

assets in order to comply with the provisions of the Rule.<sup>121</sup> This will include most types of asset-backed securities.<sup>122</sup>

The securities issued may be sold to any investor, provided that the securities received an investment grade rating, which means that they must have obtained a rating in the four highest categories for long-term debt or its equivalent for short-term debt, by at least one nationally recognised statistical rating agency.<sup>123</sup> This is yet another reason why the role of the rating agency is very important during a securitisation transaction.<sup>124</sup> Securities that do not comply with this restriction may only be sold to a specified list of investors.<sup>125</sup> These specified investors are sophisticated enough to make informed choices about riskier investments. If the SPV wants to issue such securities to investors other than those in the specified list, it will have to find an exemption in the Act and cannot rely on Rule 3a-7.<sup>126</sup>

The SPV's power to manage its pool of assets must be restricted if it wants to qualify for the exemption in terms of the Rule.<sup>127</sup> This is an important distinguishing characteristic between the SPV in securitisation and the manager of an investment company. The manager of an investment company will trade in its pool of assets depending on the changes in the market. In contrast, the Rule requires that acquisitions and dispositions of the eligible assets

- be made in accordance with the terms and conditions set out in the documents pursuant to which the asset-backed securities are issued;

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*Provided, That substantially all of the payments to which the holders of such securities are entitled consist of the foregoing amounts” (Rule 3a-7(b)(2)).*

<sup>121</sup> Rule 3a-7(a)(1).

<sup>122</sup> Dolan & Davis *Securitized* at 3-35; Wood *Project Finance* at 173–174.

<sup>123</sup> The SEC uses the term ‘Nationally Recognised Statistical Rating Organization’ (NRSRO) to indicate whether an agency’s ratings may be relied upon for purposes of the federal securities law and rules. See Exchange Act Rule 3b-10.

<sup>124</sup> See also par 2.6.

<sup>125</sup> Rule 3a-7(a)(2): “(i) Any fixed-income securities may be sold to accredited investors as defined in paragraphs (1), (2), (3), and (7) of rule 501(a) under the Securities Act of 1933 (17 CFR 230.501(a)) and any entity in which all of the equity owners come within such paragraphs; and (ii) Any securities may be sold to qualified institutional buyers as defined in rule 144A under the Securities Act (17 CFR 230.144A) and to persons (other than any rating organization rating the issuer’s securities) involved in the organization or operation of the issuer or an affiliate, as defined in rule 405 under the Securities Act (17 CFR 230.405), of such a person.”

<sup>126</sup> See Dolan & Davis *Securitized* at 3-35.

<sup>127</sup> Rule 3a-7(a)(3).

- do not result in the downgrade in the rating assigned to the SPV's outstanding fixed income securities; and
- that the assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

Despite the fact that most securitisation schemes are currently exempted from the application of the Act, it is important to remember that the SEC could revise or amend its conditions later if needs be. The SEC opted for an exemptive rule rather than an amendment of the Act. In its investigation of the possibility of abuses occurring during securitisation that are similar to the possible abuses that led to the enactment of the Investment Company Act,<sup>128</sup> the SEC concluded that although the possibility of such abuse existed it had not thus far occurred during securitisation.<sup>129</sup> A similar investigation in future may find that such abuses do occur, which could lead to greater restrictions on the possible exemption of securitisation schemes from the provisions of the Act.

#### 4.3.1.2 Securities Act of 1933 and Securities Exchange Act of 1934

For many years it was uncertain whether asset-backed securities are, in fact, 'securities' according to the definition in the Securities Act of 1933<sup>130</sup> and the

<sup>128</sup> Tamar Frankel *Securitization: Structured Financing, Financial Asset Pools, and Asset-Backed Securities* (1991) at 487 identifies the following possible abuses that may occur in both investment companies and securitisation transactions: (1) pools that hold financial assets (for instance negotiable securities) can be easily embezzled and therefore the custody of documents evidencing title to such assets must be regulated (2) the originator or sponsor and the managers of the SPV may have conflicts of interest similar to those that exist in investment companies (3) if the SPV has a discretion to change the nature of the assets held by the SPV, the risk associated with the securities may be increased if the managers substitute the assets with riskier ones. She therefore argues in favour of the regulation of the investment policies of managers.

<sup>129</sup> US SEC, Division of Investment Management *Protecting Investors: A Half Century of Investment Company Regulation* (1992) at 81–83. The SEC attributes the lack of such abuses to three factors: (1) the purchasers are institutional investors with a high degree of financial sophistication (2) usually publicly offered asset-backed securities have at least one class of highly rated securities, and (3) the originators/sponsors of asset-backed securities are mostly large well-known companies with a significant reputational stake in seeing to it that the scheme is structured fairly.

<sup>130</sup> 15 USC § 77b(a)(1). The Act makes it illegal to offer or sell securities without proper registration or an exemption from registration.

Securities Exchange Act of 1934.<sup>131</sup> The current view is that they are securities, especially when offered on the public markets.<sup>132</sup>

The Securities Act prescribes registration statements that contain appropriate disclosures to prospective investors, unless the securities or the transactions in which the securities are issued are exempt. The following asset-backed securities and transactions are exempt from the registration requirement:

- Issues by government-sponsored enterprises.<sup>133</sup>
- Issues that are backed by bank-issued letters-of-credit or guarantees.<sup>134</sup>
- Issues that qualify for a ‘private placement’ or similar exemption.<sup>135</sup>

#### 4.3.1.3 Consumer protection legislation

The recent crisis in the American subprime market led to a renewed focus on the role of securitisation in poor consumer lending practice. I will therefore briefly set out how securitisation could have contributed to some of these problems.

There are several federal statutes that aim to ensure fair lending practices. The Federal Trade Commission Act<sup>136</sup> prohibits the use of unfair or deceptive trade practices. It gives the Federal Trade Commission the power to bring action against non-compliant lenders that fall under its jurisdiction.<sup>137</sup>

The Real Estate Settlement Procedures Act<sup>138</sup> prescribes that certain information must be disclosed to prospective borrowers, such as the settlement costs of their loan, as well as the fees that will be paid to the real estate agent, the loan broker and other miscellaneous costs. It further prohibits referral fees, which unnecessarily increase the cost of settlement services.

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<sup>131</sup> 15 USC § 78c(a)(10).

<sup>132</sup> See Lupica 1998 *Texas LR* at 651–652. See further Tamar Frankel “Securitization: The Conflict Between Personal and Market Law (Contract and Property)” (1999) 18 *Annual Review of Banking Law* at 216–218.

<sup>133</sup> § 77c(a)(2). See par 4.1 for an explanation of the term ‘government-sponsored enterprise’.

<sup>134</sup> 15 USC § 77c(a)(2).

<sup>135</sup> 15 USC § 77d(2): “transactions by an issuer not involving any public offering.”

<sup>136</sup> 15 USC § 41.

<sup>137</sup> Its jurisdiction is fairly limited. For instance, it does not have jurisdiction over depository institutions, which are usually regulated by banking law. Furthermore, the fact that consumers cannot litigate on their own behalf in terms of the Act limits its usefulness. See Peterson 2007 *Cardozo LR* at 2226.

<sup>138</sup> 12 USC § 2601-2616.

The Truth in Lending Act<sup>139</sup> requires lenders to give consumers a disclosure statement that sets out the most important provisions of the credit contract in prescribed terminology. This aims to help consumers to make informed decisions and to be able to compare different credit offers. The Act makes it mandatory to include a clause in the credit agreement that the consumer may back out of the loan for up to three days after the agreement had been signed.

The Home Ownership and Equity Protection Act<sup>140</sup> created a special class of high-cost mortgages that are subject to additional regulation. A mortgage will be subject to the terms of the Act if it triggers one of two price thresholds: the first relating to the interest rate, the second to the fees associated with closing the loan.<sup>141</sup> The Act requires the lender to deliver a special notice to the prospective borrower at least three days before the loan is agreed on, in which it is stated what the percentage rate of the loan will be, the size of any balloon payments,<sup>142</sup> the cost of credit insurance charges and a notice that the consumer may still back out of the transaction.<sup>143</sup> The notice must make it clear to the consumer that she may lose her home if she cannot meet these obligations. The Act was a direct consequence of unfair lending practices that focused on vulnerable consumer groups. These loans are therefore further subject to certain substantive requirements.<sup>144</sup>

The Equal Credit Opportunity Act<sup>145</sup> and the Fair Housing Act<sup>146</sup> prohibit discriminatory behaviour in the provision of financing for housing, based on the consumer's race, gender or religion. The Acts are applicable to both mortgage loan originators and brokers.

The Fair Debt Collection Practices Act<sup>147</sup> governs abusive practices in debt collection.

<sup>139</sup> 15 USC § 1601.

<sup>140</sup> The Act appears in various sections of 15 USC.

<sup>141</sup> 15 USC § 1602(aa)(1).

<sup>142</sup> A 'balloon payment' is an inflated instalment that falls due at the end of the credit agreement.

<sup>143</sup> 15 USC § 1639.

<sup>144</sup> See Peterson 2007 *Cardozo LR* at 2227–2228.

<sup>145</sup> 15 USC § 1691.

<sup>146</sup> 42 USC § 3601–3619.

<sup>147</sup> 15 USC § 1692.

These are the main statutes that regulate consumer credit on a federal level. Most States also have legislation to further regulate fair lending practices.<sup>148</sup>

As I briefly explained in the introduction to this chapter, prime mortgages are those that qualify to be resold to one of the government-sponsored enterprises, whereas subprime mortgages are generally granted to borrowers with unacceptable credit histories that do not meet the criteria of the government-sponsored enterprises. The securitisation of subprime mortgages has become the norm in the United States since the early 1990s.<sup>149</sup>

It is now clear that unfair lending practices to consumers that only qualify for subprime mortgage loans have been rife and it is argued by some commentators that securitisation aided these practices.<sup>150</sup> The legislation set out above provides for the liability of mortgage brokers and lenders who engage in unfair lending practices. However, during securitisation the mortgage is sold to the SPV, usually with the financial backing of one or more investment banking firms. The debt is not collected by the SPV, but by a servicer who is not the holder of the claim. In other words, the originator is only involved in the life of the mortgage for a very short time, after which there may be as many as ten different participants in the securitisation process, each with its own role and gains to be made from the process.<sup>151</sup> This has led to several difficulties in the sphere of consumer protection.

The first problem is that assignee liability is often either restricted by way of a waiver of the right of the borrower to assert claims or defences against an assignee,<sup>152</sup> or by the holder in due course exception.<sup>153</sup> The holder in due course exception states that if an assignee, in good faith, paid value for a negotiable promissory note and lacked notice that the loan is in default or subject to a short list of specified consumer claims or defences, the assignee will be free of any 'personal' claims or defences that

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<sup>148</sup> See Peterson 2007 *Cardozo LR* at 2229–2230.

<sup>149</sup> Peterson 2007 *Cardozo LR* at 2214.

<sup>150</sup> Peterson 2007 *Cardozo LR* at 2215 *et seq*; Kurt Eggert "Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine" (2002) 35 *Creighton LR* 503.

<sup>151</sup> See ch 2 for a discussion of the roles of these parties.

<sup>152</sup> The legality of such waivers are expressly acknowledged in UCC § 9-403.

<sup>153</sup> The normal position is that the assignee takes subject to the claims and defences that the borrower might assert against the assignor. The Restatement (Second) of Contracts § 336(2) reads as follows: "The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment, but not to defences and claims which accrue thereafter."



the consumer may raise.<sup>154</sup> These personal claims and defences include fraud, unconscionability and, in some states, statutory claims based on unfair and deceptive trade practices. The assignee will still be liable for ‘real’ claims or defences, such as that the borrower was a minor or acted under duress. Most consumer claims for unfair lending practices will fall under the ‘personal’ class.<sup>155</sup>

Courts have declined to enforce waiver of defence clauses or holder in due course status if the assignee had notice of the consumer’s defences.<sup>156</sup> Although section 3-302 of the Uniform Commercial Code contains a list of facts of which the assignee must have lacked actual or implied knowledge, aspects that could be the basis for a personal defence do not appear in the list. The section does, however, contain a requirement that the assignee must take the instrument in good faith. The courts have held that good faith is lacking where there is a close connection between the assignor and the assignee.<sup>157</sup>

In 1975 the Federal Trade Commission introduced a regulation in terms of its authority derived from the Federal Trade Commission Act that is applicable to all contracts between consumers and financiers of consumer goods or services. The Regulation contains a clause that must be included in all such contracts to the effect that an assignee of the original lender takes the contract subject to all claims and defences that the consumer may have asserted against the original lender.<sup>158</sup> The Uniform Commercial Code was subsequently amended to provide that where the inclusion of this notice is required by federal law, state law will regard such contracts as if this clause was included, even when it was left out.<sup>159</sup> However, since a mortgage loan is not a transaction relating to a ‘sale or lease of goods or services’, as the regulation requires, this clause need not be included in mortgage agreements.

<sup>154</sup> UCC § 3-302(a)(2).

<sup>155</sup> Peterson 2007 *Cardozo LR* at 2233.

<sup>156</sup> Peterson 2007 *Cardozo LR* at 2236.

<sup>157</sup> See for instance *Unico v Owen*, 232 A.2d 405 (NJ 1967) at 411–417 (the financier was intimately involved in setting the terms of the agreements that led to the notes); *First New England Financial Corp. v Woffard*, 421 So.2d 590 (Fla Dist Ct App 1982) at 593 n 4.

<sup>158</sup> The notice reads as follows: “Any holder of this consumer credit contract is subject to all claims and defences which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder” (16 CFR § 433.2).

<sup>159</sup> UCC § 3-305(e).

Peterson<sup>160</sup> argues that there is no sound reason for such exclusion and that the regulation ought to be amended to make the inclusion of the notice in mortgage agreements compulsory.

A second problem regarding consumer protection measures is that the terminology used in consumer protection legislation is no longer extensive enough to cope with the realities of modern structured financing.<sup>161</sup> For instance, the Truth in Lending Act requires a ‘creditor’ to comply with the Act’s requirements of disclosure that must be made to the consumer when negotiating the terms of the loan agreement. ‘Creditor’ is defined as “the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness”.<sup>162</sup> But in recent times the the loan agreement is often negotiated by a broker who will never be a creditor in terms of the Act.

A third problem is that securitisation makes the process of litigation much more expensive for a consumer.<sup>163</sup> For instance, owing to the separation of the collecting function from the legal holder of the claims, and also because the claims originated with another party who is not necessarily the servicer, several parties will have to be approached during discovery. In the United States such problems are exacerbated by the Mortgage Electronic Registration System (MERS). Although originally intended to be an electronic document custodian only, the MERS is now often registered in the county registration offices’ records as the nominee holder of the mortgage. A consumer is therefore unable to ascertain the mortgagee from the public records. Even more disconcertingly, the MERS now brings foreclosure proceedings in its own name, even though it is unequipped to comply with consumers’ discovery requests and holds no financial or other interest in the loan. It succeeds in bringing the application in its own name, because the consumer is usually ill-equipped to engage in lengthy litigation in order to contest the MERS’s standing. Peterson<sup>164</sup> argues that courts ought to insist that only the true mortgagee can apply for foreclosure and that the practice of registering mortgages in the name of the MERS should not be allowed.

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<sup>160</sup> Peterson 2007 *Cardozo LR* at 2274.

<sup>161</sup> Peterson 2007 *Cardozo LR* at 2255–2263.

<sup>162</sup> 15 USC § 1602(f)(2).

<sup>163</sup> Peterson 2007 *Cardozo LR* at 2263–2269.

<sup>164</sup> Peterson 2007 *Cardozo LR* at 2280.

It remains to be seen how these problems will be addressed by the United States legislator. However, it seems clear that the extension of assignee liability alone will not be adequate to address some of the problems associated with consumer protection, nor will it be fair. The parties most likely to lose from an unlimited extension of assignee liability are the investors in the SPV, who are also innocent in that they would have been completely unaware of the unfair practices that led to the creation of the loans. Consequently, one must look at means to deflect some of the liability to the other parties to the securitisation scheme, such as the sponsors, underwriters and trustees, who are never themselves assignees, but who benefit enormously from the transaction. Peterson<sup>165</sup> suggests that courts ought to consider extending the common law principles of aiding and abetting,<sup>166</sup> conspiracy<sup>167</sup> or joint venture<sup>168</sup> to include these parties in the sphere of possible defendants that must answer to the claims of wronged consumers.

### 4.3.2 Bankruptcy law considerations

There have been very few bankruptcies of originators and SPVs in the United States.<sup>169</sup> Consequently, many of the concerns surrounding this issue have not yet been tested in courts and are debated by commentators on a theoretical basis. The aspects

<sup>165</sup> Peterson 2007 *Cardozo LR* at 2247–2255.

<sup>166</sup> The Restatement (Second) of Torts § 876(b) defines aiding and abetting as follows: “for harm resulting to a third person from the tortious conduct of another, a person is liable if he (b) knows that the other’s conduct constitutes a breach of a duty and gives substantial assistance or encouragement to the other so to conduct himself.” The aider-abetter need not have owed a duty of care to the person himself. He also need not have gained from the wrongful conduct. See Peterson 2007 *Cardozo LR* at 2247–2250.

<sup>167</sup> A civil conspiracy is “a malicious combination of two or more persons to injure another in person or property, in a way not competent for one alone, resulting in actual damages” (*Mathews v New Century Mortgage Corp*, 185 F sup 2d 874 (SD Ohio 2002) at 889). Conspirators are jointly and severally liable for all such damages, regardless of their degree of involvement. See Peterson 2007 *Cardozo LR* at 2250–2251.

<sup>168</sup> A joint venture is an association of two or more persons designed to carry out a single business enterprise for profit, for which purpose they combine their property, money, effects, skill, and knowledge (*Shell Oil Co v Prestidge*, 249 F 2d 413 (9th Cir 1957) at 414–415). The rights of the parties to a joint venture are determined with reference to partnership law, which means that the parties are jointly and severally liable for the debts of the venture. There are indications that the courts may be willing to look at a securitisation scheme as a joint venture between the different parties to the scheme. See Peterson 2007 *Cardozo LR* at 2252–2255 for a discussion of these cases.

<sup>169</sup> Katherine D Kale “Securitizing the Enterprise: Enterprise Liability and Transferred Receivables in Bankruptcy” (2003) 20 *Bankruptcy Developments Journal* at 326. This might soon change due to the turbulence in the sub-prime mortgage market and the general economic downturn experienced in the United States of America as well as in the rest of the world.

discussed in this section are important, because the insulation of the SPV from the bankruptcy of the originator is an important pillar of the securitisation scheme.

#### 4.3.2.1 Transfer of rights and ‘true sale’ requirement

The securitisation transaction must be structured in such a manner that the courts will consider the transaction to be a sale and not a secured loan. This is referred to as the ‘true sale’ requirement. When a securitisation complies with the true sale requirement, the sold assets no longer form part of the originator’s estate and are therefore isolated from the potential future bankruptcy of the originator.<sup>170</sup>

##### 4.3.2.1.1 *Bankruptcy Reform Act of 2001*

The Bankruptcy Reform Act of 2001<sup>171</sup> proposed to amend the Bankruptcy Code to provide greater certainty to investors that the transfer of assets during a securitisation transaction would be considered a sale rather than a secured loan in the event of the originator’s bankruptcy. However, although certain sections of the Bill became law, the provisions I shall discuss hereafter were never enacted out of fear of the misuse of off-balance sheet vehicles in the Enron debacle.<sup>172</sup>

If these provisions had been enacted, most assets transferred during an asset-backed securitisation scheme would have fallen outside the estate of a bankrupt originator. In terms of section 541(b)(8) of the Bankruptcy Code if amended,<sup>173</sup> from the estate would have been excluded

any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with

<sup>170</sup> According to 11 USC § 541(a)(1), such assets are no longer legal or equitable interests of the debtor and are therefore excluded from the debtor’s bankruptcy estate.

<sup>171</sup> HR 333, 107<sup>th</sup> Cong. § 912. On the provisions of the Act relating to securitisation generally, see Lupica 2000 *Connecticut LR* at 225–230; Steven L Schwarcz “The Impact of Bankruptcy Reform on ‘True Sale’ Determination in Securitization Transactions” (2002) 7 *Fordham J of Corporate & Financial Law* 353.

<sup>172</sup> Some authors such as Lupica 2000 *Connecticut LR* at 242, would have welcomed the abandonment of the proposals, because it was considered over-protective of securitisation when case law had not yet adequately tested the possible negative effects on third parties such as the unsecured creditors of the originator. Others, such as Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 353 and 365 were in favour of the proposed provisions and regarded Congress’s withdrawal as an overreaction. None of the Enron deals could be considered securitisation transactions. See Schwarcz 2004 *Cardozo LR* at 1551–1553 for an explanation of how special purpose vehicles were misused by the Enron group, as opposed to the legitimate use of such vehicles during securitisation.

<sup>173</sup> 11 USC.

an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a).<sup>174</sup>

This provision would have superseded any conflicting provision of state law, as well as precedent in terms of state law on the characterisation of a transaction as a sale or a secured loan.<sup>175</sup> It would also have meant that the avoidance powers in terms of sections 544(a)(1)<sup>176</sup> and 547(b)(5)<sup>177</sup> of the Bankruptcy Code would not be available to the trustee of a bankrupt originator.

An ‘asset-backed securitisation’ was defined as a transaction in which eligible assets transferred to an eligible entity were used as the source of payment on securities, at least one class or tranche of which were rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer.

‘Eligible assets’ were defined as financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not they were in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.<sup>178</sup> Cash and securities were also eligible assets in terms of this section.

An ‘eligible entity’ was an issuer engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking

<sup>174</sup> I consider the avoidance provisions of the Bankruptcy Code in par 4.3.2.3. In terms of 11 USC § 548(a) a transaction may only be avoided if the bankruptcy of the debtor occurs within one year after the transaction. This is a very short period in comparison to some of the state bankruptcy codes. For instance, in Alabama a transfer of real property may be avoided for up to ten years after the transaction, and up to six years for a transfer of personal property (Alabama Code § 8-9A-9). See also Edward J Janger “Muddy Rules for Securitizations” (2002) 7 *Fordham J of Corporate & Financial Law* 301 at 311.

<sup>175</sup> Lupica 2002 *Fordham J of Corporate & Financial Law* at 348–349; Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 359.

<sup>176</sup> The avoidance of unperfected security interests.

<sup>177</sup> The avoidance of transfers that result in a preference for one creditor over all creditors as a group.

<sup>178</sup> Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 358–359 argues that this definition would also include a transfer of partial interests in receivables, without the danger that the transaction would not constitute a true sale.

actions ancillary thereto, or an entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto.<sup>179</sup> In other words, an ‘eligible entity’ referred to an SPV.<sup>180</sup> The second possibility in the definition was added, because in many securitisations in the United States the assets are first sold to a subsidiary of the originator, which will constitute a true sale because the originator will not provide guarantees or recourse to its subsidiary. This SPV then transfers the assets to a security trustee for the benefit of the investors, which transaction will not constitute a true sale. This is because the SPV will retain a subordinated interest in the proceeds of the accounts and a right to any surplus. The trustee will therefore have to file a first priority security interest in the accounts.<sup>181</sup> Schwarcz<sup>182</sup> argued that the adoption of the Bankruptcy Reform Act would have lessened the need for such structures.

Section 541(f)(5) would have defined ‘transferred’ very widely to include situations where the transferor held a direct or indirect interest in the issuer (SPV) or in the securities issued by the issuer. It would also have included the situation where the transferor had an obligation to repurchase all or any of the eligible assets or to service or supervise the servicing of the eligible assets. The characterisation of the transfer under tax, accounting or for regulatory reporting purposes would have been irrelevant.

If these exceptions in the Bankruptcy Code were enacted, the possibility of the recharacterisation of the sale of the assets as a secured loan would have been largely excluded. Most asset-backed securitisation transactions would have complied with the requirements of section 541 and would not have formed part of the originator’s bankrupt estate.<sup>183</sup>

The important role of the rating agencies, referred to in the proposed section 541(f)(1) as “nationally recognized securities rating organizations”, was very obvious

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<sup>179</sup> The eligible entity could have been a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or another entity, which is such a wide description that the business form of the eligible entity is really irrelevant for compliance with this section.

<sup>180</sup> See also par 2.3 for a detailed discussion of the SPV.

<sup>181</sup> See *Wood Project Finance* at 158.

<sup>182</sup> 2002 *Fordham J of Corporate & Financial Law* at 361–362.

<sup>183</sup> Janger 2002 *Fordham J of Corporate & Financial Law* at 313; Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 357.

in these provisions.<sup>184</sup> An asset-backed securitisation would only benefit from the exception in this section if one or more of the tranches of securities issued during the securitisation received an investment grade rating.<sup>185</sup> Although most securitisations would have complied with this requirement, the ones that did not would still have been vulnerable to the recharacterisation risk. It further meant that private placing of asset-backed securities, where a rating was considered unnecessary, would not have benefited from these provisions.<sup>186</sup> Lupica<sup>187</sup> argues that this qualification meant that only Wall Street firms, with the means to have pushed this amendment forward, would have benefited from the Reform Act.

Janger<sup>188</sup> argues that reliance on the opinion of rating agencies could lead to the following result: rating agencies rely on opinions expressed by legal counsel that the transaction would constitute a true sale and would be bankruptcy remote from the originator. These considerations would have fallen away if the Act were adopted, which would have meant that the opinion of the rating agencies would only rely on the quality of the assets transferred to the SPV. Reliance on the rating also focuses the enquiry on the quality of the SPV, rather than on the potential harm that the securitisation may cause the originator and its creditors if the transaction was not a true sale or constituted a fraudulent conveyance under state law.<sup>189</sup>

Specific mention was made under the definition of ‘eligible assets’ to assets that were not yet in existence on the date of transfer. Previous versions of the Bankruptcy Reform Act did not include this phrase, which led to concerns that the securitisation of assets not yet in existence, or the securitisation of the proceeds of such assets, would not fall under the definition of ‘eligible assets’ and could therefore be at risk of

<sup>184</sup> The more correct term is ‘Nationally Recognised Statistical Rating Organization’ (NRSRO), which indicates that an agency’s ratings may be relied upon for purposes of the federal securities law and rules. See Exchange Act Rule 3b-10. In terms of the Credit Rating Agency Reform Act of 2006 (S. 3850-190<sup>th</sup> Congress) the Securities and Exchange Commission has the authority to oversee the credit rating industry. For more on the regulation of rating agencies, see Locke 2008 *De Jure* 545. Rating agencies are discussed in detail in par 2.6.

<sup>185</sup> An ‘investment grade rating’ is a term originally used by various regulatory bodies in the United States to indicate debt securities that are eligible for investment by institutions such as banks, insurance companies and savings and loan associations (pension funds). See Schwarcz 2002 *University of Illinois Law Review* at 7–8.

<sup>186</sup> See also Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 360.

<sup>187</sup> Lupica 2000 *Connecticut LR* at 228–229.

<sup>188</sup> 2002 *Fordham J of Corporate & Financial Law* at 316.

<sup>189</sup> Janger 2002 *Fordham J of Corporate & Financial Law* at 316–317.

recharacterisation.<sup>190</sup> The addition of this species of asset to the definition of ‘eligible asset’ alleviated such concerns. However, the securitisation of future assets carries more uncertainty than when assets already in existence are securitised. It would be more difficult to obtain an investment grade rating for securities backed by future assets. An investment grade rating for at least one of the tranches of the securities issued by the SPV<sup>191</sup> was the other important requirement if a securitisation were to fall under the exception in section 541.

#### 4.3.2.1.2 Future legislative intervention

Schwarcz<sup>192</sup> believes that the proposed amendments to the Bankruptcy Code ought to be reconsidered at some future date. Other authors voiced concerns that such legislative protection of securitisation transactions does not adequately take account of all the relevant issues. Lupica<sup>193</sup> argues that securitisation hampers the possibility of a successful reorganisation of a struggling originator, because its cash-producing assets are no longer part of its estate. If the assets served as security for a loan, and the assets were needed in the reorganisation process, they could be retained in the estate in return for alternative “adequate protection” of the secured creditor’s interests.<sup>194</sup> However, if the assets were sold, they would no longer be available to contribute to the originator’s effective reorganisation.

However, Schwarcz<sup>195</sup> argues that one cannot assume wasteful behaviour simply because receivables are substituted for cash. In fact, the cash boost may stave off

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<sup>190</sup> See Gordon 2000 *Univ of Chicago LR* at 1329.

<sup>191</sup> Gordon 2000 *Univ of Chicago LR* at 1342–1344 makes the following suggestions that may aid the structuring of a securitisation of future assets in order to achieve a finding of a true sale: (1) Originators should charge a lower price for the sale of the assets to represent the higher risk that some of the assets may not come into existence, without any recourse should the assets yield a higher income than expected. This may mean that securitisation becomes a less attractive financing option under the circumstances. (2) The agreements should limit the originator’s ability to control the price and quantity of the assets that is transferred to the SPV when they come into existence, in order to bring the role of the originator after the securitisation more in line with that of an administrator or servicer. (3) The originator will continue to have an obligation to generate the assets in favour of the SPV. The transaction documents must therefore include an undertaking by the originator that it will require a prospective acquirer in terms of a merger or acquisition to assume the terms of the securitisation.

<sup>192</sup> Schwarcz 2002 *Fordham J of Corporate & Financial Law* at 353.

<sup>193</sup> 2000 *Connecticut LR* at 234–236; Lupica 2002 *Fordham J of Corporate & Financial Law* at 344–345. See also Christopher W Frost “Asset Securitization and Corporate Risk Allocation” (1997) 72 *Tulane LR* at 128–129.

<sup>194</sup> 11 USC § 361.

<sup>195</sup> 2002 *Fordham J of Corporate & Financial Law* at 363–365.



bankruptcy for a while or may help the originator to avoid bankruptcy altogether.<sup>196</sup> He further argues that the interest rate saving caused by securitisation may benefit the originator's creditors, especially the unsecured creditors.<sup>197</sup> He also regards the widespread absence of restrictions on prospective securitisation transactions from debt agreements as an indication that creditors of the originator do not see securitisation as a danger to the proper fulfilment of their claims.<sup>198</sup> An empirical analysis carried out by Schwarcz of originators who had public offerings of bonds as well as securitisation offerings showed that the bond prices did not decrease after a securitisation transaction, but, in fact, increased. This shows that the creditors of the originator regarded the securitisation at least as neutral, but even as beneficial to the value of their debt.<sup>199</sup> Finally, the author argues that even if there are some creditors of the originator who are prejudiced by the transfer of the assets during a securitisation transaction, the net effect of the transaction is efficient in that the benefit to the majority of stakeholders is larger than the potential harm.<sup>200</sup>

Another aspect that needs further exploration is the effects of the sudden boost in cash after a securitisation scheme that an originator experiences on the management decisions of the originator.<sup>201</sup> If the cash injection is used in a project with positive value or for one that retains a high degree of liquidity, the securitisation will likely not affect third parties, such as the unsecured creditors of the originator, negatively. However, if the cash is used to invest in higher risk activities or for payments that will lower the originator's liquidity<sup>202</sup> it might have a negative impact on third parties. Although these risks are also present in secured lending, a secured creditor has an incentive to monitor the borrower's activities to ensure repayment of the loan and preservation of its security. Third parties, such as unsecured creditors benefit from this monitoring function. There is no one to fulfil this monitoring function after a securitisation.

<sup>196</sup> Schwarcz 2004 *Cardozo LR* at 1558–1560.

<sup>197</sup> For the advantages of securitisation, see par 2.2.

<sup>198</sup> Schwarcz 2004 *Cardozo LR* at 1563–1565.

<sup>199</sup> Schwarcz 2004 *Cardozo LR* at 1564–1565.

<sup>200</sup> Schwarcz 2004 *Cardozo LR* at 1568–1569.

<sup>201</sup> Lupica 2000 *Connecticut LR* at 236–240. Such an investigation probably belongs to a field of study outside the law.

<sup>202</sup> Such activities include the payment of current expenses and debts, dividend payouts and investment in non-liquid assets. See Lupica 2000 *Connecticut LR* at 238.

#### 4.3.2.1.3 *Current position*

As the law currently stands, every securitisation transaction will be considered to determine whether the transaction took the form of a sale or of a secured loan. This determination is derived from the equitable powers of the court,<sup>203</sup> and is largely governed by state law.<sup>204</sup> Some states have adopted legislation that provides a so-called true-sale safe harbour for determining what constitutes a true sale during a securitisation transaction. For instance, Delaware's Asset-Backed Securities Facilitation Act of 2002<sup>205</sup> provides that any asset purported in the transaction documents to be transferred in a securitisation transaction shall be deemed no longer to be the property, asset or right of the transferor.<sup>206</sup> The Act clarifies this position further by stating that "the transferor in securitization transactions, its creditors [and any] bankruptcy trustee shall have no rights, legal or equitable, whatsoever to reclaim or recharacterize as property of the transferor any property, assets or rights purported to be transferred".<sup>207</sup> Furthermore, "in the event of a bankruptcy, receivership, or other insolvency proceeding with respect to the transferor such property, assets and rights shall not be deemed to be part of the transferor's property, assets, rights or estate".<sup>208</sup>

In the absence of legislation that creates true-sale safe harbours, the courts can take one of two possible approaches in the exercise of their equitable power to recharacterise a transaction. They could use a scoring technique whereby the court considers how many attributes of a true sale the securitisation showed. Alternatively,

<sup>203</sup> Lupica 2000 *Connecticut LR* at 213.

<sup>204</sup> *Butner v United States*, 440 US 48 (1979) at 55: "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." See further Schwarcz 2004 *Cardozo LR* at 1544. In the author's opinion these common law tests in state law provide sufficient guidance to determine whether a transaction should be recharacterised. He is opposed to any attempt from a federal perspective to override these established tests (at 1545).

<sup>205</sup> 73 Del. Laws c. 214 § 1 (2002), Title 6, Chapter 27A of the Delaware Code. The Ohio Code contains a similar provision, but only where the transferor is a financial institution. See Ohio Revised Code Ann (Title 11) § 1109.75. Texas has elaborated on § 9-109 of the UCC by stating that in the absence of fraud or intentional misrepresentation the parties' characterisation of a transaction as a sale shall be conclusive and that legal and equitable title shall pass to the party characterised as the purchaser of those assets. This will be the case regardless of whether the purchaser has recourse against the seller, whether the seller has any right to a surplus or any other term of the agreement between the parties. See Texas Business & Commerce Code Ann § 9.109(e).

<sup>206</sup> § 2703A(a)(1).

<sup>207</sup> § 2703A(a)(2).

<sup>208</sup> § 2703A(a)(3).

courts could arrive at a decision after a consideration of the interests of all the parties that will be affected if the transaction is recharacterised.<sup>209</sup> Although the predominant approach in other financing transactions, such as factoring, has been to follow a scoring technique, there is definite merit in a consideration of all equities, especially a consideration of the effects of a recharacterisation on the investors in the securities issued by the SPV.<sup>210</sup> It must further be noted that when considering ordering substantive consolidation, the consideration of which is also derived from their equitable powers, courts follow the scoring approach.<sup>211</sup>

There have been no decisions that specifically considered the recharacterisation of a securitisation as a secured loan. Guidance is therefore sought from precedent in factoring transactions, where the issue has been considered. When following the scoring technique, a number of aspects emerged from case law as important to determine whether the transaction is a sale or a secured loan:

- A sale of assets usually leaves the purchaser bearing the risks associated with those assets. If the purchaser has extensive recourse against the seller for losses, this is seen as an indication of a secured loan rather than a true sale.<sup>212</sup> Most commentators regard recourse as the most significant indicator that a transaction is a secured loan rather than a sale.<sup>213</sup> The following situations were indicated in *In re Evergreen Valley Resorts, Inc* as examples of recourse that will indicate a secured loan rather than a sale:<sup>214</sup>

<sup>209</sup> Martin Bienenstock, Marc Kieselstein & David J Fischer “Recharacterization & Asset Securitization: ‘When is a Duck a Duck?’” (2002) 1 *De Paul Business & Commercial LJ* at 575 and 587.

<sup>210</sup> Bienenstock *et al* 2002 *De Paul Bus & Comm LJ* at 588.

<sup>211</sup> See par 4.3.2.2. In *In re Owens Corning* 419 F 3<sup>rd</sup> 195 (3<sup>rd</sup> Cir 2005) at 210 the following was said against the formalistic use of a checklist in an application for substantive consolidation without due regard for the principles underlying that remedy: “Too often the factors in a checklist fail to separate the unimportant from the important, or even to set out a standard to make the attempt. This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation.”

<sup>212</sup> *Major’s Furniture Mart, Inc v Castle Credit Corp*, 602 F. 2d 538 (3<sup>rd</sup> Cir. 1979) at 542–544; *In re Evergreen Valley Resort, Inc*, 23 B.R. 659 (Bankr. D. Me. 1982) at 661; *Federated Dept. Stores, Inc v Commissioner*, 51 T.C. 500 (1968) at 514–515, affirmed, 426 F.2d 417 (6<sup>th</sup> Cir. 1970); *Wood Project Finance* at 158; *Lupica 1998 Texas LR* at 639; *Frost 1997 Tulane LR* at 144; *Lupica 2000 Connecticut LR* at 213.

<sup>213</sup> Kale 2003 *Bankruptcy Developments J* at 328.

<sup>214</sup> *In re Evergreen Valley Resort, Inc*, 23 B.R. 659 (Bankr. D. Me. 1982) at 661.

- Where the assignee retains a right to payment of a deficiency on the debt if the assignment does not provide sufficient funds to satisfy the amount of the debt.
- Where the assignee acknowledges that his rights in the assigned property would be extinguished if the debt owed were paid through some other source.
- Where the assignee must account to the assignor for any amount received over the amount of the debt.
- The courts do take note of the intention of the parties as evidenced by the transaction documents.<sup>215</sup>
- The courts may consider whether the sale price was set at a fair market value as determined by independent appraisers.<sup>216</sup>
- If the transaction covers specifically identified receivables rather than an interest in a pool of receivables, this might be an indication of a sale rather than a loan.<sup>217</sup>
- Whether or not notice was given to account debtors may be taken into account.
- A purchase price at a fixed discount that reflects the expected life of the receivables, rather than an interest-like monthly payment program at a floating rate, is more in line with a sale of the receivables than with a loan.<sup>218</sup>
- In a sale the purchaser (SPV) cannot alter the terms of the agreement after the sale and the originator has no right to receive any surplus collected from the transferred receivables.<sup>219</sup>

If a securitisation transaction is recharacterised as a loan rather than a sale, the SPV will still be a secured party,<sup>220</sup> but the objective of separating the SPV from the

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<sup>215</sup> *Hatoff v Lemons & Associates, Inc. (In re Lemons & Assoc)*, 67 B.R. 198 (Bankr. D. Nev 1986) at 209–210; *In re Evergreen Valley Resort, Inc*, 23 B.R. 659 (Bankr. D. Me. 1982) at 661–662; Lupica 1998 *Texas LR* at 639; Lupica 2000 *Connecticut LR* at 214. The intention shown by the written documents are not, however, conclusive. See *Major's Furniture Mart, Inc v Castle Credit Corp*, 602 F. 2d 538 (3<sup>rd</sup> Cir. 1979) at 543.

<sup>216</sup> Lupica 1998 *Texas LR* at 639; Lupica 2000 *Connecticut LR* at 213.

<sup>217</sup> *Dewhirst v Citibank (In re Contractors Equip. Supply Co.)*, 861 F.2d 241 (9<sup>th</sup> Cir 1988) at 245; Lupica 1998 *Texas LR* at 639.

<sup>218</sup> *Dewhirst v Citibank (In re Contractors Equip. Supply Co.)*, 861 F.2d 241 (9<sup>th</sup> Cir 1988) at 245; *In re Coronet Capital Co*, 142 B.R. 78 (Bankr.S.D.N.Y. 1992) at 81; Lupica 1998 *Texas LR* at 640.

<sup>219</sup> *Dewhirst v Citibank (In re Contractors Equip. Supply Co.)*, 861 F.2d 241 (9<sup>th</sup> Cir 1988) at 245; *Bear v Cohen (In re Golden Plan of Cal. Inc.)* 829 F. 2d 705 (9<sup>th</sup> Cir 1986) at 709–711; Lupica 1998 *Texas LR* at 640; Frost 1997 *Tulane LR* at 144–145; Lupica 2000 *Connecticut LR* at 215.

potential bankruptcy of the originator would have failed. A recharacterisation will mean that the SPV will be a party to the bankruptcy proceedings of the originator and will be subject to collateral substitution, reduction in priority of payment and other alteration of rights in terms of the Bankruptcy Code.<sup>221</sup>

#### 4.3.2.2 Equitable doctrine of substantive consolidation

The equitable doctrine of substantive consolidation provides that to prevent a perceived injustice, the separate legal status of two or more entities may be disregarded so that their assets and liabilities may be consolidated and dealt with as if it is being held by one entity.<sup>222</sup> This excludes liability between the entities, which is erased after consolidation.<sup>223</sup> Courts derive their equitable powers to order substantive consolidation from section 105(a) of the Bankruptcy Code.<sup>224</sup>

Although substantive consolidation has not yet been applied to an originator and an SPV during a securitisation scheme, most commentators mention it as a possibility.<sup>225</sup> An order for substantive consolidation of a securitisation scheme would merge the assets of the SPV and those of the originator on the bankruptcy of the originator. The assets that served as security for the obligations of the SPV toward its investors will then fall in the bankrupt estate of the originator. Their security interests in the assets will be kept intact, but whereas the investors were the only creditors of the SPV, the originator may have many other secured creditors with prior claims.<sup>226</sup>

<sup>220</sup> Shupack 1999 *American Bankruptcy LJ* at 179.

<sup>221</sup> See for example 11 USC § 1129(b)(1), which grants the court the power to confirm a plan for reorganization even if it was not accepted by a particular class of creditors, as long as the plan does not discriminate unfairly, and is fair and equitable.

<sup>222</sup> *Soviero v Franklin Nat'l Bank of Long Island*, 328 F. 2d 446 (2d Cir 1964) at 448; Lupica 1998 *Texas LR* at 643–644; Gambro & McCormack 2005 *Global Securitisation and Structured Finance* at 3; Kale 2003 *Bankruptcy Developments J* at 331.

<sup>223</sup> *In re Owens Corning* 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 205; *Union Savings Bank v Augie/Restivo Baking Co Ltd (In re Augie/Restivo)*, 860 F 2d 515 (2d Cir 1988) at 518; *Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987) at 276.

<sup>224</sup> 11 USC; *FDIC v Colonial Realty Co*, 966 F.2d 57 (2<sup>nd</sup> Cir 1992) at 59 and 61; *In re Richton International Corporation*, 12 B.R. 555 (Bankr. N.Y. 1981) at 557; *Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987) at 276; *In re DRW Property Co* 82, 54 B.R. 489 (Bankr.N.D. Tex. 1985) at 494–495; Lupica 1998 *Texas LR* at 645; Kale 2003 *Bankruptcy Developments J* at 332. Section 105(a) reads as follows: “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title”.

<sup>225</sup> Kale 2003 *Bankruptcy Developments J* at 337–338.

<sup>226</sup> Frost 1997 *Tulane LR* at 111.

Substantive consolidation goes further than piercing of the corporate veil and fraudulent transfer law in that it does not affect only shareholders, nor only those creditors who were party to a fraudulent transfer. It also affects innocent creditors and mandates more than the return of specific assets to their previous owner.<sup>227</sup> Whereas the creditors of the consolidated companies could previously look only at the company with whom they contracted for payment of their claims, they must look at a much larger enterprise after consolidation, which will probably mean that they will receive less of their claim.<sup>228</sup>

Two possible rationales emerged from case law on substantive consolidation in terms of which the courts decide whether an order for substantive consolidation is justified, namely the *Augie/Restivo*<sup>229</sup> approach or the *Auto-Train*<sup>230</sup> approach.<sup>231</sup> In terms of the *Augie/Restivo* approach<sup>232</sup>

Competing considerations are merely variants on two critical factors (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.

The approach in *Auto-Train* takes these factors into consideration, but it emphasises the “substantial identity” of the entities and allows consolidation in spite of creditor reliance on separateness when the demonstrated benefits of consolidation heavily outweigh the harm.<sup>233</sup>

Whichever approach a particular court follows, it seems that there is consensus amongst the various states that the remedy must be used sparingly.<sup>234</sup> The reason for

<sup>227</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 206. See par 4.3.2.3 below for a discussion of fraudulent transfer law.

<sup>228</sup> *Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987) at 276.

<sup>229</sup> *Union Savings Bank v Augie/Restivo Baking Co Ltd (In re Augie/Restivo)*, 860 F 2d 515 (2d Cir 1988).

<sup>230</sup> *Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987). See also *In re DRW Property Co 82*, 54 B.R. 489 (Bankr.N.D. Tex. 1985) at 494.

<sup>231</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 207–208.

<sup>232</sup> *Union Savings Bank v Augie/Restivo Baking Co Ltd (In re Augie/Restivo)*, 860 F 2d 515 (2d Cir 1988) at 518.

<sup>233</sup> *Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987) at 276.

<sup>234</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 209; *FDIC v Colonial Realty Co*, 966 F.2d 57 (2<sup>nd</sup> Cir 1992) at 61; *Chemical Bank New York Trust Co v Kheel*, 369 F.2d 845 (2<sup>nd</sup> Cir 1966) at 848; *In re DRW Property Co 82*, 54 B.R. 489 (Bankr.N.D. Tex. 1985) at 494; *In re Snider Bros, Inc.* 18 B.R. 230 (Bankr. D. Mass. 1982) at 234; *In re Richton International Corporation*, 12 B.R. 555 (Bankr. N.Y. 1981) at 556; *Lupica 1998 Texas LR* at 645. See also *Kale 2003 Bankruptcy Developments J* at 332–333; *Ellis 1999 J of Corporation Law* at 306.

courts' reluctance to order substantive consolidation was expressed as follows in *In re Snider Bros, Inc.*:<sup>235</sup>

It must be recognized and affirmatively stated that substantive consolidation, in almost all instances, threatens to prejudice the rights of creditors. This is so because separate debtors will almost always have different ratios of assets to liabilities. Thus, the creditors of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor must lose to the extent that the asset-to-liability ratio of the merged assets will be lower.

In *Flora Mir Candy Corporation* this reluctance was expressed as follows:<sup>236</sup>

Because of the dangers in forcing creditors of one debtor to share on a parity with creditors of a less solvent debtor, substantive consolidation, 'is no mere instrument of procedural convenience,' but a 'measure vitally affecting substantive rights'.

In *In re Owens Corning* the Court of Appeal for the Third Circuit preferred the *Augie/Restivo* approach, rejecting the *Auto-Train* approach as "not sufficiently egregious and too imprecise".<sup>237</sup> Subsequently, the United States Supreme Court denied a petition to review the decision of the Court of Appeal, which means that the law in the third circuit at least is now settled.<sup>238</sup>

The Court *In re Owens Corning* held that when an objecting creditor relied on the separateness of the entities, consolidation could not be justified with regard to the claims of that creditor. The Court set out the following principles, which it believes underlie the remedy of substantive consolidation:<sup>239</sup>

- The general expectation of state law, the Bankruptcy Code and of the commercial markets is that courts respect the separateness of entities, in the absence of compelling circumstances calling for equity.
- The harm that substantive consolidation addresses is nearly always caused by debtors and the entities they control. Harm caused by creditors are remedied by the provisions of the Bankruptcy Code, such as those dealing with fraudulent transfers.<sup>240</sup>

<sup>235</sup> *In re Snider Bros, Inc.* 18 B.R. 230 (Bankr. D. Mass. 1982) at 234.

<sup>236</sup> *Flora Mir Candy Corp. v R.S. Dickson & Co (In re Flora Mir Candy Corp.)*, 432 F.2d 1060 (2d Cir. 1970) at 1062. See also *Chemical Bank New York Trust Co v Kheel*, 369 F.2d 845 (2<sup>nd</sup> Cir 1966) at 847; *In re Vecco Construction Industries, Inc.*, 4 B.R. 407 (Bankr. Va. 1980) at 409.

<sup>237</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 210.

<sup>238</sup> 2006 WL 1131887 (US).

<sup>239</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 211.

<sup>240</sup> See par 4.3.2.3.

- Mere benefit to the administration of a case is not sufficient to justify substantive consolidation.
- Substantive consolidation is an extreme remedy and should be rare and one of last resort.
- Substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, but not offensively. An example of offensive use would be if the application had as its primary purpose to disadvantage tactically a group of creditors in a reorganisation plan.

From these underlying principles the Court held that an applicant for substantive consolidation must either prove (1) that before the bankruptcy petition the separateness of the entities were so severely disregarded that their creditors treated them as one entity, or (2) that after the bankruptcy petition the assets and liabilities of the entities are so scrambled that it would benefit all creditors to consolidate.<sup>241</sup> This means that creditors will be able to defeat the application by showing that they are adversely affected by consolidation and actually relied on the separateness of the entities when extending credit.<sup>242</sup> The basis for a consolidation order under these circumstances is that creditors have dealt with the separate entities as one business and that the consolidation order basically gives effect to the creditors' contractual expectations.<sup>243</sup>

If the approach of the Court in *In re Owens Corning* is adopted more widely than the Third Circuit,<sup>244</sup> substantive consolidation should not really be a threat to securitisation transactions, since it can be easily avoided by proper separation and representation of the businesses of the originator and the SPV.<sup>245</sup> While the creditors of the originator might have expected to share in the assets that were transferred to the

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<sup>241</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 211. See, for instance, *GM Mather v GK Pipe Corporation (In re Moran Pipe & Supply Co.)*, 130 B.R. 588 (Bankr. E.D. Okl. 1991); *In re Murray Industries Inc.*, 119 B.R. 820 (Bankr. M.D. Fla. 1990). See also Kale 2003 *Bankruptcy Developments J* at 334–335; Frost 1997 *Tulane LR* at 147. For an example of misrepresentation of the corporate structure or of the ownership structure of the operating entity that will lead to substantive consolidation, see *Eastgroup Properties v Southern Motel Ass'n (In re Eastgroup Properties)*, 935 F.2d 245 (11<sup>th</sup> Cir 1991) at 250. Amongst other misrepresentations, funds were transferred from one entity to another and they paid each other's unsecured debts.

<sup>242</sup> *In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005) at 212.

<sup>243</sup> Lupica 1998 *Texas LR* at 644.

<sup>244</sup> And I submit that the approach seems sound and well considered.

<sup>245</sup> Frost 1997 *Tulane LR* at 148.



SPV, the creditors of the SPV relied on the SPV's separation from the originator. The SPV's creditors expected that the separate legal personality of the SPV would be upheld during the originator's bankruptcy. Consolidation therefore does not fall within their contractual expectations.<sup>246</sup> Instead, the creditors of the SPV rely on the separateness of the SPV and the originator in their decision to extend credit to the SPV.<sup>247</sup>

The principles set out in *In re Owens Corning* will also guard against the offensive use of substantive consolidation by the trustee of a bankrupt originator to limit the rights of the investors in the SPV in favour of the creditors of the originator.<sup>248</sup>

The SPV must be prohibited from any activity that would create the impression that it does not operate as a separate entity from the originator. Courts view the following as indications that consolidation may be proper:<sup>249</sup>

- The presence of consolidated financial statements.
- The entities have officers or directors in common.
- The entities share an office location.
- The entities share operational expenses.
- The bankrupt entity has control or majority ownership of the SPV.<sup>250</sup>
- The bankrupt entity has assumed the SPV's obligations, which includes the presence of inter-corporate guarantees.
- The transfer of assets without formal observance of corporate formalities.
- The degree of difficulty in segregating and ascertaining the individual assets and liabilities of the two entities. When the assets and liabilities of the entities are so

<sup>246</sup> Kale 2003 *Bankruptcy Developments J* at 335.

<sup>247</sup> In *In re Owens Corning* the creditors who opposed the application for consolidation were a syndicate of banks. Not only did the credit agreement in that case stipulate that the entities must maintain their separateness, but the banks obtained extensive information on the financial position of each of the entities that provided guarantees to their parent corporation. All of this showed that the banks relied on the separateness of the entities when they extended credit. See also *Chemical Bank New York Trust Co v Kheel*, 369 F.2d 845 (2nd Cir 1966) at 848: "Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite".

<sup>248</sup> *In re Owens Corning*, 419 F 3d 195 (3rd Cir 2005) at 215 the Court held that substantive consolidation is not a means to avoid the difficult task of proving fraudulent transfer.

<sup>249</sup> *In re Vecco Construction Industries, Inc.*, 4 B.R. 407 (Bankr. Va. 1980) at 410; *In re DRW Property Co 82*, 54 B.R. 489 (Bankr.N.D. Tex. 1985) at 495; Lupica 1998 *Texas LR* at 644; Gambro & McCormack 2005 *Global Securitisation and Structured Finance* at 3.

<sup>250</sup> Frost 1997 *Tulane LR* at 149–150 shows that equity ownership of the SPV is really a substitute for recourse. The originator's equity ownership allows it to capture collections on the accounts in excess of that needed to pay the investors in the SPV, which makes it possible to transfer the assets to the SPV at a higher discount.

intertwined that they cannot be distinguished as belonging to the one or the other, consolidation will be proper.

However, even if all of these indications are present, the overriding concern is whether consolidation would benefit creditors generally.<sup>251</sup>

Owing to the risk of substantive consolidation in American securitisation transactions, rating agencies require legal opinions that all possible steps have been taken to guard against such an order in the event of the originator's bankruptcy. However, since the remedy of substantive consolidation is dependent on the equitable discretion of the court, it is difficult to provide definite answers as to the likelihood of such an order being granted.<sup>252</sup> Substantive consolidation is also criticised as deviating from the expectations of creditors who rely on limited liability and on the basis that it places too much discretion in the hands of bankruptcy judges.<sup>253</sup>

#### 4.3.2.3 Avoidance provisions of Bankruptcy Code

Bankruptcy law is federal statutory law contained in Title 11 of the United States Code. The United States Constitution grants the United States Congress the authority to establish uniform laws on the subject of bankruptcy throughout the United States of America.<sup>254</sup> This means that although states may regulate other aspects of the debtor-creditor relationship, they are not allowed to regulate bankruptcy. Bankruptcy proceedings are supervised by, and litigated in, the United States Bankruptcy Courts, which form part of the District Courts of the United States.<sup>255</sup>

The avoidance provisions of the Bankruptcy Code are contained in sections 547 and 548 of Title 11 of the United States Code. Section 547 sets out the circumstances

<sup>251</sup> *In re Snider Bros, Inc.* 18 B.R. 230 (Bankr. D. Mass. 1982) at 238. In this case the Court refused to grant an application for substantive consolidation despite substantial evidence of a disregard of formal separateness of the different companies in the group. The mingling of the different businesses was not so severe that it was irreparable. See also *In re Richton International Corporation*, 12 B.R. 555 (Bankr. N.Y. 1981). In this case the Court followed the approach in *Vecco*, but ended its consideration of whether to allow substantive consolidation as follows: "Finally, a key factor for this Court, although not mentioned by the *Vecco* court, is that substantive consolidation of these Debtors will yield an equitable treatment of creditors without any undue prejudice to any particular group (at 558)."

<sup>252</sup> See Lupica 1998 *Texas LR* at 646-647; Kale 2003 *Bankruptcy Developments J* at 337.

<sup>253</sup> Kale 2003 *Bankruptcy Developments J* at 336.

<sup>254</sup> US Constitution Article I, Section 8.

<sup>255</sup> See also the explanation of the court system in the USA in par 4.1. For a succinct overview of the bankruptcy system in the USA, visit <http://topics.law.cornell.edu/wex/Bankruptcy> (accessed 16 May 2008).

under which a trustee may avoid a transfer of property to a creditor of the bankrupt debtor. The debt must have been incurred before the transfer and the transfer must have enabled the creditor to receive more than he would have received in terms of bankruptcy proceedings.<sup>256</sup> This section only has bearing on transfers that took place within 90 days of the filing of the petition for bankruptcy, or for a year and 90 days if the creditor was an insider.<sup>257</sup>

The provisions of section 547 will seldom be relevant to avoid a securitisation undertaken by a bankrupt originator, since the SPV will mostly not be a creditor of the originator in terms of the section. It is further rare for an originator to become bankrupt so soon after a securitisation transaction. Even if a case could be made out that the SPV was a creditor of the originator, the transaction will probably succeed on one of the following two defences set out in section 547(c), namely that the transfer was

- intended by the debtor and the creditor for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor.<sup>258</sup> ‘New value’ is defined in section 547(a)(2) as “money or money’s worth in goods, services, or new credit”;
- in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and made according to ordinary business terms.<sup>259</sup> Securitisation is a tried and tested method of financing in the United States. It is not out of the ordinary, nor is it undertaken in extraordinary business terms.

The more probable route that a trustee might take to try and avoid a securitisation transaction undertaken by a bankrupt originator is the fraudulent transfer provisions contained in section 548. In terms of section 548(a)(1) the trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor that was made or incurred on or within one year before the date of the filing of the bankruptcy petition, if the debtor voluntarily or involuntarily

<sup>256</sup> 11 USC § 547(b).

<sup>257</sup> 11 USC § 547(b)(4).

<sup>258</sup> 11 USC § 547(c)(1).

<sup>259</sup> 11 USC § 546(c)(2).

- made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted;<sup>260</sup> or
- received less than a reasonably equivalent value in exchange for such transfer or obligation.<sup>261</sup>

If the trustee relies on the second of these circumstances, he must further prove that the debtor<sup>262</sup>

- was insolvent on the date of such transfer or when such obligation was incurred, or became insolvent as a result of such transfer or obligation;
- was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;<sup>263</sup> or
- intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

The first circumstance that falls under section 548 is when the debtor intentionally made a transfer or incurred an obligation that would hinder, delay or defraud a creditor. This is often referred to in American literature as 'fraudulent transfers'. The second circumstance is similar to transactions at an undervalue in English law, and is referred to as constructively fraudulent transfers.

When a transaction is successfully avoided in terms of section 548, the trustee may recover for the benefit of the estate the property transferred or the value of the property so transferred from the initial transferee or from the immediate transferee of

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<sup>260</sup> See also § 4 of the Uniform Fraudulent Transfer Act of 1984. The provisions of the Bankruptcy Code are substantially similar to the provisions of the Uniform Fraudulent Transfer Act. The latter Act was promulgated by the National Conference of Commissions on Uniform State Laws and adopted by 43 states and the District of Columbia. The Uniform Fraudulent Transfer Act is also available to creditors outside the bankruptcy of the debtor. For this reason it is possible for a creditor to obtain an injunction to restrain a debtor or a transferee from further disposing of the assets (§ 7(a)(3)(i)). I shall contain my discussion to the Bankruptcy Code and will refer to the Uniform Fraudulent Transfer Act only where its provisions materially differ.

<sup>261</sup> See also § 5 of the Uniform Fraudulent Transfer Act.

<sup>262</sup> § 548(B)(ii)(I)–(III).

<sup>263</sup> § 4(a)(2)(ii) of the Uniform Fraudulent Transfer Act refers to 'assets' in the same context rather than 'capital'. This is the more correct wording, since 'capital' has a specific meaning within corporate law which is far narrower than intended in the course of fraudulent conveyance law. See Comment 4 on § 4 of the Official Comment on the Uniform Fraudulent Transfer Act.

the initial transferee.<sup>264</sup> However, the trustee may not recover such property from a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or any immediate good faith transferee of such transferee.<sup>265</sup>

#### 4.3.2.3.1 *Fraudulent transfers*

It is generally agreed among commentators that there is no real risk that a securitisation scheme will be found to be a fraudulent transfer. The transactions are not conducted in secret and they do not carry the ‘badges of fraud’.<sup>266</sup> The term ‘badges of fraud’ refers to the development of a list of indications which the courts over time agreed upon as showing that fraudulent intent was present during a transaction.<sup>267</sup>

The Uniform Fraudulent Transfer Act of 1984 elaborates on aspects that the court may consider determining whether the debtor had actual intent to defraud, hinder or delay payment, without forming a closed list. Section 4(b) lists the following aspects, which corresponds to some extent with the common law ‘badges of fraud’:

- Whether the transfer was to an insider.<sup>268</sup> The SPV might be an affiliate of the originator and therefore an insider, but this aspect alone is not conclusive to justify the conclusion that there was intent to defraud.
- Whether the debtor retained possession or control of the property transferred after the transfer. If the transferred assets are claims and the originator continues to service these claims, it might be argued that the originator continued to exercise

<sup>264</sup> 11 USC s 550(a).

<sup>265</sup> 11 USC s 550(b). See also § 8(a) of the Uniform Fraudulent Transfer Act.

<sup>266</sup> Frost 1997 *Tulane LR* at 114.

<sup>267</sup> These were first set out in *Twyne's Case*, 3 Coke Rep. 80b, 76 Eng. Rep. 809 (Star Chamber 1601). The following were held to be signs that an asset was disposed of with fraudulent intent: (1) A gift has the signs of fraud. (2) The donor remained in possession of the thing and used it as his own, which led others to deal with him and which deceived and defrauded them. (3) The disposition was made in secret. (4) The disposition was made during impending litigation against the donor. (5) There was a trust between the parties. (6) The deed of transfer contains a provision to the effect that the disposition was made honestly, truly and *bona fide*.

<sup>268</sup> In terms of § 1(7)(ii) an ‘insider’, if the debtor is a corporation, includes a director or officer of the debtor and a person in control of the debtor. § 1(7)(iv) provides that an affiliate is also an insider. If the debtor directly or indirectly owns, controls, holds or has the power to vote on 20 per cent or more of the outstanding voting securities of a corporation, the latter will be an affiliate of the debtor (§ 1(1)(ii)). A person whose business is operated by the debtor under a lease or other agreement, or a person all of whose assets are substantially controlled by the debtor, will also be an affiliate in terms of the Act (§ 1(1)(iii)).

control over those assets. However, this aspect again is not conclusive on its own to lead to a finding of fraudulent intent.

- Whether the transfer was disclosed or concealed. Transfers during securitisation transactions are disclosed at least in the financial statements of the originator, even if the SPV's securities are privately placed. It therefore cannot be argued that these transactions are as a rule concealed. However, if it does emerge that a particular transaction was not disclosed in the prescribed manner in the financial statements of the originator, this will undoubtedly raise questions.
- Whether the debtor was sued or threatened with suit before the transfer was made. This aspect might be of importance if it is coupled with an accusation that the originator misused the securitisation scheme to effect judgment proofing.<sup>269</sup>
- Whether the transfer included substantially all the debtor's assets.
- Whether the debtor absconded. This aspect is more relevant to natural persons.
- Whether the debtor removed or concealed assets.
- Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred.
- Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- Whether the transfer occurred shortly before or shortly after a substantial debt was incurred.
- Whether the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

The presence of one or more of these aspects may point to the required intent, but it does not create a presumption of such intent.<sup>270</sup> Instead, the court will evaluate all relevant circumstances involving a challenged transfer.<sup>271</sup>

#### 4.3.2.3.2 *Constructively fraudulent transfers*

'Reasonably equivalent value' is not defined in the Act.<sup>272</sup> Cases that considered 'reasonably equivalent value' have generally held that 'fair market value' constitutes

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<sup>269</sup> See par 2.2.6.2.

<sup>270</sup> See Comment 5 on § 4 of the Official Comment on the Uniform Fraudulent Transfer Act.

<sup>271</sup> See Comment 6 on § 4 of the Official Comment on the Uniform Fraudulent Transfer Act.

‘equivalent value’ and have then proceeded to consider what percentage of that value would constitute *reasonably* equivalent value. However, these cases mostly dealt with value received at public auctions and did not specifically consider value received for a sale of financial assets.<sup>273</sup>

The scrutiny of rating agencies, credit enhancers, stock exchanges and other participants in the scheme will probably ensure that the SPV provides ‘reasonably equivalent value’ for the transferred assets. Even if low-quality assets are heavily discounted, the consideration received will probably still comply with the reasonably equivalent value criterion.<sup>274</sup>

Another reason why the transaction will usually not be avoidable under this provision is that the transaction will usually not leave the originator bankrupt, nor will the originator be bankrupt before it enters into the scheme.<sup>275</sup>

#### 4.3.2.4 Doctrine of enterprise liability

The doctrine of enterprise liability entails that courts should ignore the separate legal personality of holding companies and subsidiaries when they function as a single integrated enterprise.<sup>276</sup> As in the case of substantive consolidation this doctrine has not yet been used in bankruptcy proceedings against an originator, and the discussion of its possible use is voiced theoretically by commentators.

Enterprise liability can either follow from a disregard of the corporate formalities, which is similar to piercing of the corporate veil, or it may follow on proving that the one corporation is really acting on behalf of the other and is subject to the control of the other. The latter form is referred to as ‘agency enterprise liability’ and is put forward by some commentators as an alternative to substantive consolidation to reach the assets of the SPV during the bankruptcy of the originator.<sup>277</sup> The effect of a successful application for enterprise liability is the same as that of substantive

<sup>272</sup> Nor is it defined in s 3(a) of the Uniform Fraudulent Transfer Act, which provides a general definition of ‘value’.

<sup>273</sup> See Jason HP Kravitt *Securitization of Financial Assets* 2 ed (2008) at 5-182.

<sup>274</sup> See Lupica 1998 *Texas LR* at 648; Frost 1997 *Tulane LR* at 115.

<sup>275</sup> Frost 1997 *Tulane LR* at 115.

<sup>276</sup> Kale 2003 *Bankruptcy Developments J* at 338. The doctrine is available under state law and is confined by the principles of individual state law. Here I only discuss general principles.

<sup>277</sup> Kale 2003 *Bankruptcy Developments J* at 339.

consolidation: the assets of the subsidiary will be available for the creditors of the holding company.

The possibility of invoking enterprise liability in the United States is a result of the corporate structure often found between the originator and the SPV. The SPV is often a wholly owned subsidiary of the originator, which means that it is easier to show that the two companies function as one economic entity.<sup>278</sup>

However, there are considerations that make a finding of enterprise liability more difficult. As in the case of substantive consolidation, the court will take into account the possible prejudice to the creditors of the affiliated company if a finding of enterprise liability is made.<sup>279</sup> A further point of uncertainty is whether the bankruptcy trustee will have standing to invoke enterprise liability on behalf of the creditors of the estate. Outside bankruptcy, only the creditors of the holding company will have standing to pursue the remedy. The issue has not yet been resolved, and each state takes its own view on the matter.<sup>280</sup>

#### 4.4 CONCLUSION

Sales of the type of asset most commonly used during securitisation transactions must adhere to the requirements of Article 9 of the Uniform Commercial Code. If a transaction is a sale, the transferred assets will no longer form part of the transferor's estate. However, Article 9 does not contain guidance as to when a transaction is a sale.<sup>281</sup> Such guidance must instead be found in precedent from the individual states on when it is necessary to recharacterise a purported sale as a secured loan.<sup>282</sup>

Recharacterisation is a risk for securitisation, because the rating assigned to the securities issued by the SPV is dependent on a finding that the assets are permanently severed from the estate of the originator by way of a true sale and will therefore not be affected by the possible bankruptcy of the originator. The rating agencies rely on opinions by legal counsel in this regard.

Contrary to the approach in English law, legislation in the United States on federal and state level aims to clarify and simplify the legal position with regard to

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<sup>278</sup> Kale 2003 *Bankruptcy Developments J* at 342–343.

<sup>279</sup> Kale 2003 *Bankruptcy Developments J* at 344.

<sup>280</sup> Kale 2003 *Bankruptcy Developments J* at 344–348.

<sup>281</sup> See par 4.2.2.

<sup>282</sup> See par 4.3.2.1.



securitisation.<sup>283</sup> However, this does not extend as far as creating a federal ‘true sale safe harbour’ for securitisation transactions as is found in the state of Delaware. A ‘true sale safe harbour’ was proposed as an amendment to the Bankruptcy Code in 2001, but the proposals were subsequently abandoned.<sup>284</sup> It follows that the characterisation of the transaction as a sale remains important in the event of the originator’s bankruptcy.

My analysis of the legislative provisions surrounding securitisation further shows that several uncertainties remain about the efficiency of securitisation as a financing tool.<sup>285</sup> There are specific concerns that securitisation may cause prejudice to unsecured creditors of the originator for which they cannot renegotiate interest rates and which therefore goes uncompensated. There are also concerns that securitisation removes cash-generating assets from the originator, who may subsequently be unable to reorganise, should it land in economic difficulty. I have set out the arguments for and against these points of view. I favour the view expressed by Schwarcz that securitisation probably does not cause harm to unsecured creditors that outweigh the benefits of the financing tool. However, a more definite picture should emerge when the efficiency of securitisation has been empirically tested.

The brief description of consumer protection legislation shows that even in the United States, where securitisation has a much longer history than in South Africa, legislation cannot keep track with the rapid evolution of the practices that accompany this form of financing.<sup>286</sup>

Courts take one of two approaches when considering the characterisation of a transaction, namely a scoring approach or an all-equities approach. The former takes into account a list of considerations that courts have previously determined to show that a transaction was either a sale or a secured loan. The transaction type that receives the most ticks wins the characterisation race. In the all-equities approach the court considers all parties who will benefit or will be prejudiced by recharacterisation and then takes a decision that will favour most interested parties. There have as yet been no cases where a recharacterisation of securitisation transactions has been

<sup>283</sup> See par 4.3.1.

<sup>284</sup> See par 4.3.2.1.1.

<sup>285</sup> See par 4.3.2.1.

<sup>286</sup> See par 4.3.1.3.

considered, but in factoring transactions the scoring approach has so far been favoured.<sup>287</sup>

I considered the equitable doctrine of substantive consolidation as applied by the courts at state level.<sup>288</sup> The approach of the court in the Third Circuit is to refuse an application for substantive consolidation if it would cause harm to a specific creditor, because that creditor extended credit to one entity based on its belief that the entity is separate from the other. The consolidation must benefit all the creditors of the merged entities. Furthermore, substantive consolidation is not to be used as an offensive tool to prejudice one group of creditors in favour of another group. If this approach is to be applied more widely than the Third Circuit, and it seems to me to be sound, substantive consolidation ought not to be a substantial risk to securitisation transactions. This is because it is easy to keep a clear corporate distinction between an originator and the SPV. Furthermore, the expectations of the creditors of the SPV will be that the SPV will be treated as an entity separate from the originator.

It seems that a securitisation scheme should not often be at risk of avoidance in terms of the provisions of the Bankruptcy Code.<sup>289</sup> The SPV will usually not be a creditor of the originator in terms of section 547 and even if it were a creditor, one or more of the exceptions under that section will probably apply to the transaction. The transaction will usually not be a fraudulent transfer in terms of section 548, because it does not carry one of the 'badges of fraud' associated with such transactions and is not conducted in secret. Nor will it be a constructively fraudulent transfer, because reasonable equivalent value is given in return for the transfer of the assets and the transaction will seldom leave the originator bankrupt or be carried out whilst the originator is bankrupt.

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<sup>287</sup> See par 4.3.2.1.3.

<sup>288</sup> See par 4.3.2.2.

<sup>289</sup> See par 4.3.2.3.

**PART III  
SOUTH AFRICAN LAW**



## CHAPTER 5

# DEBT FINANCING OF COMPANIES

### 5.1 COMPANY DEBT

A company obtains the funds it needs to conduct its business from two possible sources.<sup>1</sup> The first source is share capital obtained from the issue of shares to shareholders, also called ‘equity financing’.<sup>2</sup> The second source is funds obtained from outside parties in the form of loans or credit supplied, also called ‘debt financing’. Funds obtained from long- and short-term creditors together represent ‘external equities’ on the balance sheet of a company. From these two sources a company can reach a wide variety of potential investors, ranging from single persons to large institutional investors such as pension funds. The ability of a company to attract large investments is one of its advantages as a business form.<sup>3</sup>

A company may decide to opt for debt rather than equity financing for a variety of reasons.<sup>4</sup> Compared to equity, debt financing is a relatively cheap way to raise money.<sup>5</sup> Furthermore, unless the current shareholders can afford to raise the additional funds themselves, the issue of new equity dilutes ownership.<sup>6</sup> Debt financing may also have favourable tax implications, since the payment of interest is considered an expense that leads to lowered taxable income.<sup>7</sup>

<sup>1</sup> Cilliers *et al Corporate Law* at 199–200.

<sup>2</sup> On share capital generally, see Kathleen Emmarencia van der Linde *Aspects of the Regulation of Share Capital and Distributions to Shareholders* (2008 thesis Unisa).

<sup>3</sup> See also SJ Naudé *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) at 2.

<sup>4</sup> Keith Ward *Corporate Financial Strategy* (1993) at 174.

<sup>5</sup> Michael J Barclay & Clifford W Smith Jr “The Capital Structure Puzzle: Another Look at the Evidence” in Donald H Chew *The New Corporate Finance: Where Theory Meets Practice* 3 ed (2001) at 209.

<sup>6</sup> See Barclay & Smith in Chew *New Corporate Finance* at 200 fn 6 for an example of this principle. Suppose a company has 100 members. It needs further capital of R100 and it is decided that 100 shares of R1 each will be issued to raise this capital. If the original 100 members take up all the freshly issued shares there will still only be 100 members of the company. However, if 100 other persons take up these shares there will now be 200 members, each with voting rights and rights to dividends. This means that the original 100 members will now have a smaller slice of the cake when decisions are taken and dividends declared.

<sup>7</sup> Merton H Miller “The Modigliani-Miller Propositions after Thirty Years” in Chew *New Corporate Finance* at 189 refers to interest payments as the ‘costs of doing business’. In this article the writer examines his propositions set out in conjunction with Franco Modigliani in an article “The Cost of Capital, Corporation Finance and the Theory of Investment” (1958) 47 *American Economic Review* 261 and (1959) 48 at 655. The gist of these propositions is that the value of a firm is independent of its capital structure (its debt–equity ratio). They then postulate that the gains from using debt capital

### 5.1.1 Gearing

The higher a company's debt is in relation to its equity (debt-equity ratio), the greater the possibility of higher returns for shareholders when the company's business performs well. This is referred to as 'gearing' and may be explained as follows:<sup>8</sup>

If a company has 100 ordinary shareholders who each holds one share at a par value of R1 000 and debentures of R100 000 bearing interest at 10 per cent per annum, the company has raised capital of R200 000 and its debt-equity ratio is 1:1. The company will have to show an annual profit of at least R10 000 to pay the interest due. If the company shows a profit of less than R10 000, the shareholders will not receive any dividends. However, all the profit above R10 000 will, depending on management's strategy, be available for dividends. If the company is performing well, it can afford to have fewer shareholders who receive a higher return on investment.

Suppose the same company shows a profit of R100 000. In the given scenario the first R10 000 must go towards the service of the debt instrument. R90 000 is still available for dividend distribution, which means that each shareholder may receive up to R900 in dividends.

Now suppose that the company did not make use of gearing, but chose to raise all its capital by way of equity. It raised R200 000 from the issuance of 200 shares at a par value of R1 000 each to 200 shareholders. The full R100 000 is available for dividend distribution, but since it has to be divided by 200, each shareholder may receive a maximum of R500 in dividends.

It is obvious that the company in this example could afford even higher gearing. Suppose the company converted 50 of its ordinary shares into preference shares, redeemable at the option of the company, and the company redeems them. It then

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is offset by the increase in risk to the holders of equity capital. However, these propositions rest on the assumption that there are no external influences due to tax, imperfect information, transaction costs and bankruptcy costs. These propositions were later elaborated on by the authors in "Corporate Income Taxes and the Cost of Capital: A Correction" (1963) 53 *American Economic Review* 433. They argued that income tax may be significantly reduced by using debt, which in turn leads to higher returns for shareholders. Miller comes to the conclusion that recent developments in taxation law in the United States of America mean that the benefits of debt capital for that country remain unchanged since the publication by Modigliani and himself of their 1963 article. Barclay & Smith in *Chew New Corporate Finance* at 199 make the valid comment that many financing theories fail to consider the fact that the investor will have to pay income tax on interest received. In other words, debt may have tax benefits for the company but not for the investor.

<sup>8</sup> For very interesting case discussions of the dynamics of debt policy in the financial strategy of companies, see W Carl Kester, William F Fruhan Jr, Thomas R Piper & Richard S Ruback *Case Problems in Finance* 11 ed (1997) at 147–216. The simple example that follows forms the basis of many aspects considered by companies when deciding on the extent of their exposure to debt.

continues to raise R50 000 through the issuance of further debentures on the same terms as the first series of debentures. The company still has capital in the amount of R200 000 but it now has a debt–equity ratio of 3:1.<sup>9</sup>

Suppose the company shows a profit of R100 000. It pays R15 000 in interest on its debt instruments. It still has R85 000 available for dividend distribution. However, there are now only 50 shareholders. This means that each shareholder may receive up to R1 700 in dividends.<sup>10</sup>

From this example one may draw the following conclusions: first, debt is only a truly viable option to raise finances if the company is mature, meaning that it has reached its full economic potential within a specific industry.<sup>11</sup> Second, there is always the risk that the financial situation of the company may change for the worse, in which case the shareholders carry the risk of no or little return on their investment. This is often cited as one of the reasons why companies may opt not to use debt

<sup>9</sup> For the sake of simplifying the example, the costs of conversion and of the further issuance of the debentures will not be discussed. Another factor that is usually considered is the terms of repayment of the debt. If the debt becomes repayable in yearly instalments, this must be incorporated in the company's income projections. It might also be prudent to create a reserve in the form of a sinking fund to assist in the company's eventual capability to repay the debt. See for instance "Continental Carriers, Inc" in Kester *et al Case Problems* at 147–149 and "Crown Corporation" in Kester *et al Case Problems* at 205–209.

<sup>10</sup> The ideal debt–equity ratio of a company will depend solely on the circumstances. It should be determined with reference to the maximisation of the market value of the company. Stewart C Myers "Determinants of Corporate Borrowing" (1977) 5 *Journal of Financial Economics* at 170–171 argues that a company will never use its maximum potential debt, because borrowing should proceed on the book value of the assets of a company, rather than their market value. Its maximum potential debt will probably be closer to the market value of its assets, but then the debt becomes risky and may lead to the company taking value-reducing decisions. This is so because the creditors, and not the shareholders, will carry the risk of the failure of the enterprise. This theory is interesting for purposes of this thesis, because it leads to the parallel conclusion that the maximum amount of a company's debt should be equal to the maximum assets available to offer as security for the debt.

<sup>11</sup> Michael C Jensen "Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers" (1986) 76 *American Economic Review* at 324; Barclay & Smith in Chew *New Corporate Finance* at 200 and 207 show that debt is especially attractive to large, mature public companies with large cash flows that cannot be profitably reinvested in the company. This may lead to an inclination by managers to sustain growth in the company at the expense of profitability, due to overinvestment in the company's core business or due to diversification into unfamiliar areas. Coupled with the principle of gearing explained above, higher interest payments may be a more effective way of distributing the excess cash. Building on this reasoning, debt is seen as a less suitable option for high-growth companies (see Bennett Stewart in *Bank of America Roundtable on the Link between Capital Structure and Shareholder Value* held at Pebble Beach, California (June 25, 1997) in Chew *New Corporate Finance* at 266–267). In these companies financial flexibility is seen as more urgent than savings on tax or control benefits. Since free cash can be channelled into profitable investment opportunities, debt becomes less necessary. See also Myers 1977 *JFE* at 170.

financing.<sup>12</sup> This risk may be countered by vesting both control of the shareholding and the risky debt in the same institution or person.<sup>13</sup>

It should be borne in mind that lenders will insist on monitoring the company to ensure that their investment and security are not at risk. This may lead to some operational restrictions on the company. However, some argue that higher leveraging in a company leads to better management, since managers must work harder to reach the interest targets created by debt capital and that it also leads to a more conservative approach when considering new ventures.<sup>14</sup> Stewart<sup>15</sup> commented that because increased debt usually leads to more concentrated ownership of shares – often in the hands of insiders – the incentive for stricter control is also increased.

### 5.1.2 Insider debt

Operational restrictions that come with monitoring arrangements, sometimes referred to as ‘restrictive covenants’ in English law, may make debt less attractive for small high-growth companies, because they need to invest in research and development in order to achieve ultimate sustainability. Restrictive covenants serve as a disincentive for these companies to opt for debt financing. A further reason why start-up

<sup>12</sup> See Miller in Chew *New Corporate Finance* at 185 and 190; Barclay & Smith in Chew *New Corporate Finance* at 200. Companies may also decide not to make use of their full debt potential in order to retain the flexibility of emergency reserves. See Miller & Modigliani 1963 *American Economic Rev* at 441.

<sup>13</sup> Miller in Chew *New Corporate Finance* at 191–192. According to the author this strategy is often used successfully in Japan, where the debt–equity ratios are higher than in the United States.

<sup>14</sup> See Miller in Chew *New Corporate Finance* at 191–192. The financing theories of ‘signalling’ and the ‘pecking order’ are also relevant. Signalling entails that debts are considered a credible ‘signal’ to investors that the company is undervalued, because managers that believe their assets are undervalued will rather issue debt than equity. For example, if the company’s shares are trading at 200 cents per share, but the managers believe the share is really worth 220 cents, a new issue of shares will generate 20 cents per share less capital for the company than the managers know the shares to be worth. Debt now becomes more attractive. The ‘pecking order’ entails that new investments should be financed from the cheapest available source of funds. According to this theory, the first option should always be internal funding (retained earnings), followed by debt (due to the reasoning followed in signalling) and as a last resort, equity. However, case studies show mixed reliability of the theories of signalling and the pecking order, because many companies take financing decisions directly contradicting these assumptions. It is therefore best to keep them in mind but not to attach too much significance to these theories. See Barclay & Smith in Chew *New Corporate Finance* at 201–202 and 205–206. Myers 1977 *JFE* at 161 argues that managers accept monitoring costs, because they have decided that it will benefit the company to accept them. In other words, though the managers may complain about operational restrictions, they probably traded the acceptance of the covenants for lower interest rates.

<sup>15</sup> At the “Bank of America Roundtable” discussed in Chew *New Corporate Finance* at 250. See also the comments of Cheryl Francis at 257.



companies may avoid debt is that such companies often do not have assets to offer as security, which means that they are charged higher interest rates.<sup>16</sup>

When these companies decide to raise debt financing, they prefer to make use of bank loans or privately placed debt. Privately placed debt is debt placed at a selected few investors rather than the larger public, therefore often with institutional investors.<sup>17</sup> Bank loans and privately placed debt have been termed ‘insider debt’, referring to the situation where the lender is privy to more management information than the general public because it serves on the board of the company or on some of its management structures.

The use of ‘insider debt’ by smaller companies has several potential advantages. Assuming that the bank has better knowledge of, and thus more confidence in, a company’s ability to comply with the loan, it may be willing to provide the debt at a better interest rate. Banks may be in a better position to monitor the company and there may be more confidentiality of the venture to be financed by the loan. Lastly, insider debt makes the costly approval of listing on a securities exchange unnecessary.<sup>18</sup>

A secondary motivation for using bank loans or private debt, which applies to both large and small companies, is that stock market reaction to the issuance of public debt is more negative. A possible reason for this is that investors regard the longer dates of maturity associated with public debt (on average 20 years) as a negative signal, namely that the management of the company is not positive about the company’s long-term credit position. By contrast, bank loans and private debt usually have shorter maturity dates, which indicate management’s expectations of a positive cash

<sup>16</sup> Michael J Barclay & Clifford W Smith Jr “On Financial Architecture: Leverage, Maturity, and Priority” in Chew *New Corporate Finance* at 214–217. Lenders still insist on security when providing finance to small high-risk companies. This often takes the form of security by means of receivables. The authors quote (at 220) the Chief Financial Officer of an American bank that specializes in providing finance to Silicon Valley technology firms: “Secure everything you can. Attaching assets not only increases your chances of getting paid back, but also deters borrowers from bringing in junior creditors. Junior creditors are likely to cause big problems if the firm has trouble servicing the debt.”

<sup>17</sup> Eugene F Fama “What’s Different about Banks?” (1985) 15 *Journal of Monetary Economics* at 36–38; Cristopher James & Peggy Wier “Are Bank Loans Different?: Some Evidence from the Stock Market” in Chew *New Corporate Finance* at 326. See also Oditah *Global Securities Market* at 93–94.

<sup>18</sup> James & Wier in Chew *New Corporate Finance* at 328.

flow.<sup>19</sup> They also signal that banks, with their improved ability to assess the company, regard the company as creditworthy.<sup>20</sup>

From the above it may be concluded that some of the factors that a company's management will keep in mind when choosing between equity and debt financing are:

- debt financing can be beneficial to shareholders
- the risks associated with debt financing are less in companies that have reached maturity in their specific industries
- debt financing is a less-attractive financing option for small, high-growth companies, because the restrictive agreements contained in debt financing agreements may conflict with their aims of research and development
- if they do decide on debt financing, smaller companies will often prefer 'insider debt'
- even mature companies may prefer 'insider debt' in order to avoid negative signalling caused by the issuance of debt securities on a securities exchange.

## 5.2 DEBENTURES

The South African Companies Act<sup>21</sup> provides for the issuance of one specific form of corporate debt, namely debentures.<sup>22</sup> A discussion of debentures is important in the context of securitisation, because the SPV will usually issue debentures as a means of obtaining funds for the purchase of the assets from the originator.<sup>23</sup>

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<sup>19</sup> James & Wier in Chew *New Corporate Finance* at 331–332.

<sup>20</sup> Fama 1985 *JME* at 37.

<sup>21</sup> 61 of 1973, ss 116–131. Debentures are sometimes referred to as 'bonds'.

<sup>22</sup> On debentures generally, see Blackman *et al Commentary* at 5-325 *et seq.* There are two licensed securities exchanges in South Africa that offer facilities for the trade of debt securities, namely Yield-X on the JSE Limited and the Bond Exchange of South Africa. See generally JG van der Merwe, RB Appleton, PA Delpont, RW Furney, DP Mahony & M Koen as edited by MK Havenga, IM Esser, WD Geach, N Locke, MR Vermaas & DP Mahony *South African Corporate Business Administration* (2008) at 10-37 *et seq.* The Bond Exchange of South Africa defines a 'bond' as "an interest-paying debt instrument with a redemption date of one year or more after its issuance" ([www.bondexchange.co.za](http://www.bondexchange.co.za) (accessed 31 October 2008)). Since the Companies Act 61 of 1973 does not qualify debentures in terms of their redemption date, it can be said that all bonds are debentures, but not all debentures will qualify as bonds.

<sup>23</sup> See ch 2 for a discussion of the form and function of securitisation.

### 5.2.1 Definition

The meaning of the term ‘debenture’ has not yet been adequately defined in South African law.<sup>24</sup>

In terms of section 1(1) of the Companies Act,<sup>25</sup> a debenture includes debenture stock, debenture bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. This is clearly not an attempt to define the term ‘debenture’.

According to *Cilliers and Benade*,<sup>26</sup> no comprehensive definition of the term has been formulated. They provide an ordinary commercial definition according to which a ‘debenture’ means “a document or certificate issued by a company designating itself a debenture, which acknowledges the indebtedness of a stated sum of money, and specifies the rate of interest and the repayment dates and conditions of repayment”.<sup>27</sup>

*Henochsberg*<sup>28</sup> defines a ‘debenture’ as “any document, however it may be described, and whatever form it may take, which creates or acknowledges indebtedness in the company to another for moneys advanced or to be advanced on loan”. According to the authors, the phrase “and any other securities of the company” in section 1(1) of the Companies Act refers to “documents embodying obligations of the company to repay moneys advanced or to be advanced on loan which are secured by property whether owned by the company or by another”.<sup>29</sup> This interpretation constitutes a replication of their definition of ‘debenture’. Furthermore, there is nothing to suggest that these ‘securities’ will be secured. In fact, the Companies Act states unambiguously that these securities need not necessarily constitute a charge<sup>30</sup> on the assets of the company.

<sup>24</sup> A precise definition is also still lacking in English law. See *Davies Gower and Davies’ Principles* at 807–809.

<sup>25</sup> 61 of 1973.

<sup>26</sup> *Cilliers et al Corporate Law* at 235. See also *Pretorius et al Hahlo’s* at 170; *MS Blackman et al “Companies”* in *WA Joubert et al The Law of South Africa Vol 4* (1995) at 203–204.

<sup>27</sup> *Cilliers et al Corporate Law* at 236.

<sup>28</sup> *Meskin et al Henochsberg* at 227.

<sup>29</sup> *Idem*.

<sup>30</sup> ‘Charge’ is a term used in English law to refer to equitable security over property. See par 3.2. South African law does not know this form of security and its use in the Companies Act is therefore unsound.

This use of the word ‘securities’ in the definition provided in the Companies Act is unfortunate. Elsewhere reference is made to the Securities Services Act<sup>31</sup> for a definition of the term.<sup>32</sup> There ‘securities’ are widely defined.<sup>33</sup> It could not have been the intention of the legislature that the definition used there should be read into the definition of debentures, since that would mean that the term ‘debentures’ includes ‘shares’. I submit that ‘securities’ was probably included to cover all miscellaneous cases of debt owed by the company, specifically in the course of raising capital,<sup>34</sup> whether secured or unsecured and regardless of whether it is documented in the way a debenture usually is.

The definition provided by *Blackman*<sup>35</sup> is, in my opinion, so far the best attempt at defining debentures:

In the context of company law, a debenture is essentially a written acknowledgement of indebtedness, irrespective of its form, executed by the company, which may (but need not) include terms providing for the indebtedness to be secured by a charge over property of the company.

There should not be a strong emphasis on the document that evidences the acknowledgement. The use of the term ‘debenture’ was received into South African law from English law.<sup>36</sup> South African courts relied on English judicial interpretation to understand the scope of ‘debenture’. In the early English decision *English and*

<sup>31</sup> 36 of 2004.

<sup>32</sup> See, for instance, ss 91A(1), 134(c) and 140A(1) of the Companies Act 61 of 1973. The Stock Exchanges Control Act 1 of 1985 was repealed by the Security Services Act 36 of 2004 which provides for the definition of ‘securities’ in s 1.

<sup>33</sup> Section 1 of the Securities Services Act 36 of 2004 defines ‘securities’ as follows: “**securities**” – (a) means – (i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 45 of 2002); (ii) notes; (iii) derivative instruments; (iv) bonds; (v) debentures; (vi) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investments Schemes in terms of section 65 of that Act; (vii) units or any other form of participation in a collective investment scheme licenced or registered in a foreign country; (viii) instruments based on an index; (ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and (x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the *Gazette* to be a security for the purposes of this Act; (xi) rights in the securities referred to in subparagraphs (i) to (x); (b) excludes – (i) money market instruments except for the purposes of Chapter IV; and (ii) any security contemplated in paragraph (a) specified by the registrar by notice in the *Gazette*.

<sup>34</sup> As opposed to trade credit extended by suppliers.

<sup>35</sup> *Blackman et al Commentary* at 5-326.

<sup>36</sup> See ch 1 n 13 for a description of the development of South African company law legislation.

*Scottish Mercantile Investment Company, Limited v Brunton*<sup>37</sup> the Court of Appeal distinguished between three usual forms of debentures, namely an acknowledgement of debt<sup>38</sup>

- 1 under seal
- 2 coupled with a charge on the property of the company to secure the repayment of the debt
- 3 coupled with a charge on the property of the company and an agreement that the company is restricted from giving a prior charge to a third party.

The definition of *English and Scottish Mercantile Investment Company, Limited v Brunton* was accepted unchanged into South African law in *Coetzee v Rand Sporting Club*.<sup>39</sup> The Rand Sporting Club never issued debentures to Coetzee, acknowledging a debt of £1 600 at 12,5 per cent interest. The agreement was that the principal amount would become payable upon the non-payment of such interest for one month. The Rand Sporting Club remained in arrears and Coetzee called in the money lent and the interest due. It was then alleged by the Rand Sporting Club by means of an exception that the agreement was only for the issuance of debentures, and that the debentures should be issued first before the plaintiff could sue for the principal amount and interest.

<sup>37</sup> *English & Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700 CA. Earlier attempts by English courts to interpret the definition of 'debenture' were also not very conclusive. In *Edmonds v Blaina Furnaces Company*; *Beesley v Blaina Furnaces Company* [1887] 36 Ch 215 the Court found that 'debenture' has no real definition, but that it is often used to describe instruments of a company of which a register must be kept, even though the terms used in the Companies Act of 1862 were 'mortgages' and 'charges'. These obligations or covenants to pay a debt are then usually accompanied by a charge or security (at 219). This decision was followed in *Levy v Abercorris Slate and Slab Company* [1887] 37 Ch 260 at 263. The Court refused to accept an argument that a debenture must necessarily follow in a series of instruments and accepted that a single debenture may also be issued. A 'debenture' was described as a document that either created a debt or acknowledged it, but the Court refused to be any more restrictive in giving a definition (at 264). A document will be treated as a debenture if the legal effects intended by the document are those of a debenture, regardless of whether the document was called something different (at 265). It is noteworthy that these early cases are contemporaneous with the decisions that founded the definition of the floating charge in English law. See in this regard par 3.2.1. This may be one reason why debentures and floating charges are so closely associated and often ill-distinguished. See *In re Brightlife Ltd* [1987] Ch 200 at 214: "The floating charge was invented by Victorian lawyers to enable manufacturing and trading companies to raise loan capital on debentures. It could offer the security of a charge over the whole of the company's undertaking without inhibiting its ability to trade."

<sup>38</sup> At 712. Also see *British India Steam Navigation Company v The Commissioners of Inland Revenue* (1881) 7 QBD 165 at 172.

<sup>39</sup> *Coetzee v Rand Sporting Club* 1918 WLD 74 at 76–77.

The Court held that a company could not through a refusal to deliver a debenture deed evade its obligation to pay interest. I agree with the Court's approach, namely that any definition of a debenture cannot revolve around the document that evidences it, but should rather focus on the loan agreement.

A debenture document is to a debenture what a share certificate is to a share.<sup>40</sup> A share certificate evidences the title of the shareholder. The person registered as a member of a company may be a nominee of the real owner of the share.<sup>41</sup> Therefore, the register of members and the share certificate are only *prima facie* evidence of the ownership of shares.<sup>42</sup> Share certificates are not negotiable instruments.<sup>43</sup> A 'share' in the company has a legal meaning separate from the certificate that evidences it, namely "a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends".<sup>44</sup>

Similarly a 'debenture' should be defined, without reference to the document that evidences it, as a claim against a company, issued by a company to meet its capital requirements, where the holder is usually entitled to interest at specified intervals and repayment of the capital amount at a specified time. The contract between the debenture-holder and the company may also provide for other rights and obligations. However, the emphasis is on the nature of the debenture as a claim and the fact that it is issued for the capital requirements of the company which implies a longer term of maturity for the loan than that granted by trade creditors.<sup>45</sup> This point of view is

<sup>40</sup> This conclusion is supported by s 126(4) of the Companies Act 61 of 1973, which provides that a debenture or debenture certificate is *prima facie* evidence of the title of the person named therein. 'Debenture' here refers to the document, but it is only given evidentiary importance.

<sup>41</sup> *Sammel v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) at 666; *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* 1976 (1) SA 441 (A) at 453.

<sup>42</sup> Section 94(1) of the Companies Act 61 of 1973.

<sup>43</sup> On the definition of 'shares' and the legal effect of share certificates generally, see Pretorius *et al Hahlo* at 148–149 and 168–169. See further Van der Linde *Share Capital* at 259 *et seq.*

<sup>44</sup> *Standard Bank of SA Ltd v Ocean Commodities Inc* 1983 (1) SA 276 (A) at 288.

<sup>45</sup> PA Delpont *Die Verkryging van Kapitaal in die Suid-Afrikaanse Maatskappyereg met Spesifieke Verwysing na die Aanbod van Aandele aan die Publiek* (1987 thesis UP) at 87 places the emphasis on the document: "Alhoewel die skepping of erkenning van 'n skuld die voorvereiste vir 'n skuldbrief is, is dit duidelik dat die begrip skuldbrief nie slegs op die onderliggende skuld dui nie maar veral op die dokument waarin die skuld beliggaam is." However, the authority he offers for this point of view deals with *bearer* debentures (*Randfontein Estates Gold Mining Co Ltd v Custodian of Enemy Property* 1923 AD 576 at 580). Delpont agrees that the current lack of a proper definition is unsatisfactory (at 115–116).

enhanced by the fact that debt securities may be traded in dematerialised form on the Bond Exchange of South Africa and on the JSE Limited via Yield-X.<sup>46</sup>

Unless specifically issued as bearer debentures, debentures are non-negotiable instruments. The document is more important for the definition of a ‘debenture’ if it is a bearer debenture.<sup>47</sup> A ‘bearer debenture’ is a negotiable instrument and may be transferred by mere delivery of the document without notice to the company.<sup>48</sup> A *bona fide* transferee for value takes the bearer debenture free from the defects of title of the transferor.

The various definitions explored above and the provisions of the Companies Act specific to debentures lead to the following summary:

- A debenture-holder is a creditor of the company. As such he is entitled to interest and repayment of the capital amount advanced (redemption) as indicated by the terms of the issue.
- These terms, or conditions, must be indicated on the debenture document, otherwise the document will not be *prima facie* evidence of the debenture-holder’s title to the debenture.<sup>49</sup> This is then also the primary function of the debenture document, also referred to as the ‘debenture certificate’.

<sup>46</sup> ‘Dematerialisation’ refers to the elimination of physical certificates or documents of title which represent the ownership of securities so that the securities exist only as electronic records (Strate Ltd *Draft Bonds Blueprint Version 3.9* (2006) at 57). Approximately 34 per cent of debt securities traded on the Bond Exchange of South Africa were certificated in March 2006 (Strate Ltd *Bonds Blueprint* at 5). All new listed bonds are issued in immobilised format, except for National Treasury and Eskom Bonds. Strate Ltd sets as an objective that all securities should be dematerialised (Strate Ltd *Bonds Blueprint* at 15). It recommends that any new security that is not dematerialised should not be allowed to be listed on the Bond Exchange or Yield-X and that existing certificated securities traded on the Bond Exchange must be reduced (Strate Ltd *Bonds Blueprint* at 16). Strate Ltd identifies the reluctance by issuers to dematerialise as a constraint on these objectives (Strate Ltd *Bonds Blueprint* at 39). The International Organisation of Securities Commissions has issued 19 Recommendations for Securities Settlement Systems. Recommendation 6 is that securities should be dematerialised to the greatest degree possible (Strate Ltd *Bonds Blueprint* at 47). Strate Ltd aims to adhere to international best practice.

<sup>47</sup> *Randfontein Estates Gold Mining Co Ltd v Custodian of Enemy Property* 1923 AD 576 at 580: “A bearer debenture is an acknowledgment of debt in favour of the holder as a creditor of the Company for the specified amount with a right to interest therein as stipulated.” See also Blackman *et al Commentary* at 5-349.

<sup>48</sup> Meskin *et al Henochsberg* at 230; Blackman *et al Commentary* at 5-349.

<sup>49</sup> Section 126(1) read with s 126(4) of the Companies Act 61 of 1973. See also Blackman *et al Commentary* at 5-349.

- Debentures can be secured or unsecured.<sup>50</sup> This must also be clearly indicated on the debenture certificate. Debentures issued by an SPV will always be secured by the assets transferred from the originator.<sup>51</sup>

The registration of debenture-holders,<sup>52</sup> the issuance of debenture certificates,<sup>53</sup> the transfer of debentures<sup>54</sup> and the holding of a debenture by a nominee<sup>55</sup> are regulated by the Companies Act in a manner similar to shares. These aspects are less important for purposes of this discussion.

### 5.2.2 Debenture stock

Debentures may be issued in series where every debenture represents a separate debt. Alternatively, a single debt may be created and debenture stock certificates issued to subscribers in such amounts as each wants, usually subject to a prescribed minimum amount.<sup>56</sup> The holder of debenture stock certificates is a participant with the other holders in the whole of the stock. He may sell and transfer any fraction of the amount issued to him.

Although the individual debenture stockholders are issued with debenture stock certificates, the contract is usually entered into between the company and the trustees for the debenture stockholders.<sup>57</sup> The trustees are the creditors of the company and the debenture stockholders are only the beneficiaries of the trust. The contract may provide that interest and repayment of the loan is made to the trustees, or it may provide that the company will make payment directly to each debenture stockholder.

Such an arrangement does not, however, change the character of the scheme. The debenture stockholders are not creditors of the company. Consequently, a debenture

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<sup>50</sup> Sections 116 and 117 of the Companies Act 61 of 1973. See also par 5.4 below.

<sup>51</sup> This process was discussed in ch 2.

<sup>52</sup> Sections 128–130 of the Companies Act 61 of 1973.

<sup>53</sup> Section 91A of the Companies Act 61 of 1973. For a discussion of the issuance of debentures, see FJ Dreyer “Praktiese Aspekte Rakende die Uitreiking van Skuldbriewe as Wyse om Beleggersfondse te Mobiliseer” (1993) 2 *TSAR* 287.

<sup>54</sup> Sections 133–169 of the Companies Act 61 of 1973.

<sup>55</sup> Section 140A of the Companies Act 61 of 1973.

<sup>56</sup> Blackman *et al Commentary* at 5-328.

<sup>57</sup> See also par 2.8.2.2.3.



stockholder will usually not have remedies against the company, but will have to take action against the trustee in case of default.

The issuance of debenture stock as explained above is much more satisfactory from a theoretical point of view when the trustee holds security in favour of the debenture-holders. Since they are equal beneficiaries under the trust, the debenture stockholders will rank *pari passu* without any need for legislative intervention as is the case with debentures issued in series.<sup>58</sup> More importantly, the trustee for debenture stockholders will be both the creditor and the security taker of the company. Such a construction therefore complies with the accessory nature of real security rights.

### 5.2.3 Security

The rest of this chapter evaluates one further aspect that may influence the company's decision whether to raise further finance by way of equity or debt financing, namely the company's ability to provide adequate security to the lender.

Debentures may be secured by the movable and immovable property of a company.<sup>59</sup> The binding of movable property as security for debentures may be effected through pledge,<sup>60</sup> notarial bond<sup>61</sup> and cession *in securitatem debiti*.<sup>62</sup>

A company must keep a register of pledges, cessions, notarial bonds, mortgage bonds and notarial debentures<sup>63</sup> affecting the property of the company.<sup>64</sup> The register must give a short description of the encumbered property, as well as the name and addresses of the security takers. The idea behind this provision is that it must provide

<sup>58</sup> Section 120 of the Companies Act 61 of 1973 provides: "In any bond or deed of pledge executed in favour of a trustee for debenture-holders generally, provision may be made that the debentures thereby secured or to be secured may be issued from time to time and at different dates, as the company may determine, but all such debentures, whenever issued, shall rank in preference concurrently with one another as from the date on which the pledge was constituted or the bond was registered." This provision can only have effect if the debentures were issued in series.

<sup>59</sup> Section 117 of the Companies Act 61 of 1973. A debenture must be clearly described as either secured or unsecured on the debenture, debenture certificate and in a prospectus relating to the issue of debentures (s 125 of the Companies Act 61 of 1973).

<sup>60</sup> Section 117(1)(a) of the Companies Act 61 of 1973.

<sup>61</sup> Section 117(1)(b) of the Companies Act 61 of 1973.

<sup>62</sup> Section 117(1)(c) of the Companies Act 61 of 1973: "the pledging of incorporeal rights by means of cession of such rights, whether present or future, in due and proper form". Obviously this section does not distinguish between a pledge of rights and a fiduciary security cession, but it is broad enough so that both forms of security by means of claims are possible.

<sup>63</sup> In terms of s 119 if a debenture was executed before a notary public, it may be registered in the deeds registry as if it were a notarial bond.

<sup>64</sup> Section 127 of the Companies Act 61 of 1973.

a means for third parties, including investors, to ascertain the creditworthiness of a company.<sup>65</sup>

Although section 117 is included in that part of the Act that deals with debentures, it is not restricted to security granted in favour of debenture-holders. If the aim of the register is that third parties, including potential investors, may gain information about the extent to which a company has encumbered its property as security, the register ought to include all security granted by a company. This includes security for loans other than debentures.

It is important that the law allows for effective security to be taken over most of the company's assets.<sup>66</sup> Debentures are usually only in demand when they are secured, which makes the availability of security even more important.

#### **5.2.4 Provisions of Companies Bill 61 of 2008<sup>67</sup>**

The Companies Bill does not contain any definition of 'debenture'. Instead, it deals with all securities issued by a company that are not shares in clause 43. Clause 43(1)(a) states that a 'debt instrument'

- (i) includes any securities other than the shares of a company, irrespective of whether or not issued in terms of a security document, such as a trust deed; but
- (ii) does not include promissory notes and loans, whether constituting an encumbrance on the assets of the company or not.

This description does not define a 'debt instrument'. Although it is not entirely clear from the description above, I do not think that the legislature, by using the word 'instrument', intends to require debt securities to be issued in documentary form. This will not be in accordance with the general objective of dematerialising securities offered to the public.<sup>68</sup> According to clause 43(1)(b), a security document includes

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<sup>65</sup> Meskin *et al Henochsberg* at 235.

<sup>66</sup> Phillip Wood *Comparative Law of Security and Guarantees* (1995) at 10 refers to 'comprehensive business security' as a universal or general business charge. He defines this as "security over all of the present and future assets of a corporate debtor, including its inventory and receivables." According to Wood, the floating charge found in English law is the type of charge that complies most with this definition. Although the author does not state so expressly, it seems that he regards the possibility of the appointment of a receiver to manage, and possibly to sell, the business as a whole as a determining factor in the classification of security as 'universal' or 'general'. Recent developments in English law have more or less removed this possibility for holders of the floating charge. See par 3.2.4.

<sup>67</sup> For a detailed discussion of the relevant sections of the Bill, see par 6.6.

<sup>68</sup> See my comments in n 46.

any document by which a debt instrument is offered or proposed to be offered, embodying the terms and conditions of the debt instrument including, but not limited to, a trust deed or certificate.

The lack of a definition in the Bill means that my comments above on the meaning of the term also apply to the Bill.

As in the current Act, the Bill requires that the security document must clearly indicate whether the debt instrument is secured or unsecured.<sup>69</sup> However, the Bill does not indicate what forms of security may be used to secure debt instruments. This is to be welcomed, because it should be possible to secure debt instruments with any form of security available to secure claims generally. An attempt to describe these forms of security in the Companies Act only leads to uncertainty.<sup>70</sup>

### 5.3 PURPOSE OF SECURITY

The most important purpose of security is to ensure payment of the debt. This is achieved by providing the lender with priority over other creditors in case of the debtor's insolvency,<sup>71</sup> and by providing the lender with a right of recourse against a specific asset of the debtor in case of the latter's non-performance on the principal debt. The priority of a security may be ascertained from the date of registration<sup>72</sup> or from the date on which control was taken of the thing delivered as security.<sup>73</sup> The effectiveness of the security is closely linked to the priority it can give its taker. If several security interests are created over the same asset, the one created first in time will have priority over those created later in time. This is in accordance with the maxim "*qui prior est tempore, potior est iure*".<sup>74</sup>

<sup>69</sup> Clause 43(4).

<sup>70</sup> See also my comments in par 2.8.2.2.2.1.

<sup>71</sup> Goode *Legal Problems* at 1.

<sup>72</sup> Priority is determined by the date of the registration for mortgages (s 102 of the Deeds Registries Act 47 of 1937) and special notarial bonds (s 1(1)(a) of the Security by Means of Movable Property Act 57 of 1993).

<sup>73</sup> Priority of pledge is determined with reference to the date and time that the pledged object came into the control of the pledgee: Hugo de Groot *Inleydinge tot de Hollandsche Rechts-Geleertheyt Bevestigd met Placaten, Hand-Vesten, ouder Herkomen, Rechten & c. & c. Midsgaders Eenige Byvoegsels en Aanmerkingen op de zelve*, Simon van Groenewegen van der Made (1767) at 2 48 26–28; Johannes Voet *Commentarius ad Pandectas* 20 1 12 as translated by Percival Gane *The Selective Voet being the Commentary on the Pandects (Paris edition of 1829) by Johannes Voet (1647–1713) and the Supplement to that Work by Johannes van der Linden (1756–1835)* (1958); Simon Van Leeuwen *Het Rooms-Hollandsch Recht* 10 ed (1732) at 4 12 1.

<sup>74</sup> [Priority in time gives priority in law.] See *Digesta* 20.4.11pr; *Codex* 8 18 4 (Imp Antoninus): "*sicut prior es tempore, ita potior iure.*" [as you are first in time, so you shall have preference in law]. Verified from Danielis Elsevirii, Janssonio-Waesbergios, Johannis à Someren, Abraham

A secondary purpose of security is to provide its holder with a measure of control over the assets of the borrower.<sup>75</sup> This is especially true if the security is granted over a substantial part of the debtor's assets. This control may be increased through the use of contractual restrictions on the borrower.

The ability of a borrower to offer security may give it the opportunity to gain access to finance it otherwise would not be able to access or to obtain financing at more favourable terms.<sup>76</sup>

## 5.4 SECURING DEBT IN SOUTH AFRICA

### 5.4.1 General

South African law distinguishes two forms of security, namely personal security and real security.

The most common forms of personal security are suretyship and guarantees.<sup>77</sup> Suretyship is an accessory contract in terms of which a person (the surety) undertakes to the creditor of another (the principal debtor), primarily, that the principal debtor, who remains bound, will perform his obligation to the creditor and, secondarily, that if and so far as the principal debtor fails to do so, he, the surety, will perform, or failing that, indemnify the creditor.<sup>78</sup> Guarantee is a contract in terms of which a person (the guarantor) undertakes to perform the obligation of the principal debtor when the specified circumstances arise.<sup>79</sup>

The grantor of personal security makes its personal estate available to the creditor in the event of the debtor's default, whereas the grantor of real security makes a specific object available to the creditor in the event of the debtor's default. Real security provides the creditor with a limited real right to the security object. The creditor may be paid from the execution proceeds of the security object before other

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Wolfgang & Theodori Boom *Corporis Iuris Civilis. Tomus Primus, Quo continentur Institutionem Libri Quatuor, et Digestorum five Pandectarum Libri Quinquaginta* (1681).

<sup>75</sup> Goode *Legal Problems* at 2.

<sup>76</sup> Goode *Legal Problems* at 2.

<sup>77</sup> For the difference between suretyship and guarantee, see CF Forsyth & JT Pretorius *Caney's The Law of Suretyship in South Africa* 5 ed (2002) at 30–32.

<sup>78</sup> *Trust Bank of Africa Ltd v Frysch* 1977 (3) SA 562 (A) at 584F; *Sapirstein v Anglo African Shipping Co (SA) Ltd* 1978 (4) SA 1 (A) at 11H; *Nedbank v Van Zyl* 1990 (2) SA 469 (A) at 473H.

<sup>79</sup> Forsyth & Pretorius *Caney's* at 30.

creditors.<sup>80</sup> In the event of the debtor's insolvency, secured creditors are paid from the proceeds of the security object before other creditors. The most notable forms of real security are mortgage, pledge and notarial bonds.<sup>81</sup>

A mortgage provides a real security right to the creditor over the immovable property of the security grantor. Publicity of the creation of a mortgage is ensured by means of registration.<sup>82</sup>

Pledge provides a real security right to the creditor over a specific movable object of the security grantor. Delivery of the pledged object is necessary to fulfil the publicity requirement and thereby effectively constituting the pledge with effect against third parties.<sup>83</sup> The security grantor loses control of the pledged objects. This makes pledge an unsuitable form of security for most businesses, because a business usually uses its movable assets in its normal commercial activities.<sup>84</sup> For this reason, notarial bonds provide a more practical form of security over movable property.

Notarial bonds provide security over movable property, but the grantor remains in control of the security objects. Publicity to third parties takes place by means of registration in the Deeds Office.<sup>85</sup> South African law recognises two forms of notarial bond, namely (1) special notarial bonds and (2) general notarial bonds.<sup>86</sup>

The Security by Means of Movable Property Act<sup>87</sup> introduced special notarial bonds after some confusion had arisen as to the priority of notarial bonds registered

<sup>80</sup> For detailed discussions of real security rights in the South African law, see CG van der Merwe *Sakereg* 2 ed (1989) at 605 *et seq*; TJ Scott & Susan Scott *Wille's Law of Mortgage and Pledge in South Africa* 3ed (1987); Badenhorst *et al Silberberg* at 357 *et seq*.

<sup>81</sup> These security interests are negotiated between the creditor and the security grantor (express mortgages), but there are forms of real security that are vested in the creditor by law (tacit mortgages). These are the landlord's tacit hypothec, the tacit hypothec of the hire-purchase seller and liens (rights of retention). For more on these forms of security see Van der Merwe *Sakereg* at 698–708 and 711–726, Scott & Scott *Wille's* at 85–105; Badenhorst *et al Silberberg* at 403 *et seq*.

<sup>82</sup> Section 102 of the Deeds Registries Act 47 of 1937. On mortgage generally, see Scott & Scott *Wille's* at 48–52; Badenhorst *et al Silberberg* at 358 *et seq*.

<sup>83</sup> See n 73.

<sup>84</sup> See Van der Merwe *Sakereg* at 651–652. On pledge in general, see Scott & Scott *Wille's* at 56–65; Badenhorst *et al Silberberg* at 390–395.

<sup>85</sup> Section 61(1) of the Deeds Registries Act 47 of 1937. Companies need only register the notarial bond in the deeds registry for the area in which their registered office is situated (s 62(4)). See also *Hare v Trustee of Heath* (1884–1885) 3 SC 32 at 34.

<sup>86</sup> 'Notarial bond' is defined in s 102 of the Deeds Registries Act 47 of 1937 as "a bond attested by a notary public hypothecating movable property generally or specially." On notarial bonds generally, see GF Lubbe "Mortgage and Pledge" in WA Joubert *et al The Law of South Africa Vol 17 Part 2* ed (2008) at 287 *et seq*; Badenhorst *et al Silberberg* at 384 *et seq*.

<sup>87</sup> 57 of 1993.

over specific movable property.<sup>88</sup> Priority of special notarial bonds is determined with reference to the date of registration of the bonds.<sup>89</sup>

Section 1 of the Act provides that notarial bonds hypothecating corporeal movable property specified and described in the bond in a manner that makes it readily recognisable and which were registered after commencement of the Act, provide the holder with a real security right in that property similar to pledge, even though no delivery of the property took place.

The following conclusions may be drawn from section 1:

- Only corporeal movable property may be the subject of a special notarial bond. Claims cannot be used as security in this manner,<sup>90</sup> nor can intellectual property be the object of a special notarial bond.
- It must be possible to describe the object of the special notarial bond in such a manner that it is readily recognisable. This leads to the exclusion of certain revolving asset classes, such as stock-in-trade.<sup>91</sup> It is also uncertain whether it

<sup>88</sup> In *Cooper NO v Die Meester* 1992 (3) SA 60 (A) the Appellate Division, as it then was, held that notarial bonds over specifically determined movable property did not give the security holder any preference over concurrent creditors with regard to the free residue, unless possession of the goods was taken before the insolvency of the debtor. (At 85G: “Dit volg dat die spesiale notariële verband van bepaalde roerende sake in die onderhawige geval nie ’n statutêre preferensie verleen nie en gevolglik het dit geen preferensie bo ander konkurrente skuldeisers ten opsigte van die vrye oorskot nie”.) This was confirmed by the Appellate Division on the same date in *Sentraalwes (Koöp) Bpk v Die Meester* 1992 (3) SA 86 (A). The *Cooper* decision had significant consequences for many security holders, who took this kind of security under the false impression that the priority they would receive was either similar to that provided for expressly in Natal by virtue of the Notarial Bonds (Natal) Act 18 of 1932, or would at least provide them with a preference similar to that provided by a general notarial bond. That Natal Act provided that a notarial bond over specially noted movable property enjoyed the same priority as would a pledge, regardless of the absence of possession of the goods. The situation was rectified by the Security by Means of Movable Property Act 57 of 1993, which basically extended the Natal situation to the rest of the country. The Natal Act was repealed (s 3), but case law relating to that Act remains relevant to the application of the Security by Means of Movable Property Act 57 of 1993. Special notarial bonds registered before commencement of the Security by Means of Movable Property Act 57 of 1993 were given a preference similar to that of general notarial bonds (s 1(3)). See also JC Sonnekus “Die Notariële Verband: ’n Bekostigbare Figuur teen Heimlike Sekerheidstelling vir ’n Nuwe Suid-Afrika?” (1993) 1 *TSAR* 110; Susan Scott “Notarial Bonds and Insolvency” (1995) 58 *THRHR* 673; Jeanne Cilliers “Notarial Bonds as Security for the Payment of Debts: The Current Legal Position Explained” (1994) 35 *Codicillus* 36. On the position in the common law, see n 98.

<sup>89</sup> Section 1(1)(a) of the Security by Means of Movable Property Act 57 of 1993.

<sup>90</sup> This has been criticised by Scott 1995 *THRHR* at 683.

<sup>91</sup> See *Ikea Trading und Design AG v BOE Bank Ltd* 2005 (2) SA 7 (SCA) at 14I–15B: “the unique item of property must be readily recognisable from its description in the bond ... Where a generic item is sought to be pledged it is the unique item that is the subject of the pledge and it is not enough to describe it only with reference to its generic characteristics.” This judgment applied the approach in *Rosenbach & Co (Pty) Ltd v Dalmonte* 1964 (2) SA 195 (N) at 204G–205A where it was stated with reference to the Notarial Bonds (Natal) Act 18 of 1932: “it is not a compliance with the statute to describe the assets to be hypothecated in wide general terms, as ‘goods, wares, merchandise,

would be possible to describe property to be acquired in future in a readily recognisable manner as required by this section.

- Since a special notarial bond provides the holder with a real security right similar to a pledge, the bondholder can follow the property in the hands of a subsequent purchaser, regardless of whether the latter was aware of the special notarial bond.<sup>92</sup>

General notarial bonds extend over all the movable property of the security grantor.<sup>93</sup> Control of the security object is unnecessary to establish the bond and the bond may also cover claims<sup>94</sup> and intellectual property rights of the security grantor.<sup>95</sup> As such, it is the most comprehensive form of security that a company may grant over its assets in South African law. However, unperfected general notarial bonds only provide their holders with a preference on the insolvency of the debtor.

In the next paragraph I elaborate on this form of security. The discussion of general notarial bonds is followed by an overview of security by means of claims. I focus on these two forms of security, because they are the means by which claims may be offered as security. In this thesis I assume that the assets transferred to the SPV are claims. The claims are used as security for the debt instruments issued by the SPV.

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stock-in-trade, fixtures, fittings, furniture and appliances.’ It is necessary to know what are the goods, wares, merchandise and so on, the nature of them and the types or kind of each of them, and also the number of them.’ This specific description must be contained in the bond document itself. It cannot be implied into the bond, since this would depend on the leading of extrinsic evidence of facts only known to the parties to the bond and not to outsiders who depend on the information in the bond to determine the creditworthiness of the company (*Durmalingam v Bruce NO* 1964 (1) SA 807 (D) at 812G–813B with reference to the Notarial Bonds (Natal) Act 18 of 1932 and approved in the *Ikea Trading* decision). See, however, JC Sonnekus “Omskrywing van Sekerheidsobjekte vir die Doeleindes van die Wet op Sekerheidstelling deur Middel van Roerende Goed 57 van 1993” 2005 *De Jure* at 135–136, where the author argues that the *Ikea* decision leaves enough scope for the objects to be described separately from the registered deed in a register of assets, an inventory list or by reference to an identifying mark on the encumbered assets. See also JC Sonnekus “Sekerheidsregte: ’n Nuwe Rigting” 1983 *TSAR* 230 at 245.

<sup>92</sup> See *Bokomo v Standard Bank van SA Bpk* 1996 (4) SA 450 (C) at 455F; JC Sonnekus “Spesiale Notariële Verband, Beskikkingsbevoegdheid en Logiese Vooroordeel” 1997 *TSAR* 154.

<sup>93</sup> South African law does not allow the creation of a general bond over both the movable and immovable property of the security grantor. See s 53(1) of the Deeds Registries Act 47 of 1937.

<sup>94</sup> *Netherlands Bank of South Africa v Yull’s Trustee & The United Building Society* 1914 WLD 133.

<sup>95</sup> *Rosenbach & Co (Pty) Ltd v Dalmonte* 1964 (2) SA 195 (N); *Hymie Tucker Finance Co (Pty) Ltd v Alloyex (Pty) Ltd* 1981 (4) SA 175 (N). See further Lubbe in Joubert *et al* *LAWSA* at 360.

## 5.4.2 General notarial bonds

### 5.4.2.1 Priority

An unperfected<sup>96</sup> general notarial bond does not provide real security to the holder, but only a statutory preference over the unsecured creditors of the company on its insolvency.<sup>97</sup> This statutory preference is in relation to the entire free residue of the debtor company, which includes property and proceeds from any source.<sup>98</sup> The preference is therefore not limited to the proceeds of the movable property, but extends over the proceeds of the total of the estate of the company remaining after the appropriate real securities, expenses and earlier preferences have been paid.<sup>99</sup> This includes the proceeds from immovable property.

When several unperfected general notarial bonds exist over the movable assets of the company, priority is determined with reference to the date of registration of the bonds.<sup>100</sup>

<sup>96</sup> A general notarial bond could be made into a pledge if the bondholder takes control of the security objects. This is referred to as perfection. See par 5.4.2.4 below.

<sup>97</sup> Section 102 of the Insolvency Act 24 of 1936. Also see Lubbe in Joubert *et al* LAWSA at 362.

<sup>98</sup> This has always been the position in relation to the general notarial bond. See Philip Sacks “Notarial Bonds in South African Law” (1982) 99 *SALJ* at 611; Scott & Scott *Wille’s* at 68–69.

<sup>99</sup> In *Vrede Koöp Landboumaatskappy Bpk v Uys* 1964 (2) SA 283 (O) at 286D it was held that a general notarial bond over a part of the debtor’s movable property, which is essentially an unregistered special notarial bond, creates a preference over concurrent creditors, not in terms of the Insolvency Act 24 of 1936, but in terms of the common law. This is because the Insolvency Act 24 of 1936 did not amend or repeal the common law on this matter. However, this does not automatically lead to the assumption (as was made by Sacks 1982 *SALJ* at 613) that only the proceeds left from the security objects of such a special notarial bond will be available for this preference. See also Scott & Scott *Wille’s* at 68. The *Vrede Koöp* decision was subsequently rejected by the Appellate Division in *Cooper NO v Die Meester* 1992 (3) SA 60 (A) at 85H. The Appellate Division held that the legislator intended s 102 to be applicable only to general notarial bonds over *all* the movable property of the debtor (at 85D). A common law preference afforded to special notarial bonds would be contrary to the closed number of preferences listed in ss 96–102 of the Insolvency Act 24 of 1936 (at 85F). The conclusion was that such special notarial bonds do not afford any preference to their holders (at 85G). The holders of such special notarial bonds will be concurrent creditors of the insolvent estate and such claims will rank lower than subsequent general notarial bonds. Since the *Cooper* decision, the Security by Means of Movable Property Act 57 of 1993 was enacted, which provides for the creation of special notarial bonds (see n 88). Special notarial bonds created before the commencement of the Act (7 May 1993) were provided with a preference above the concurrent creditors of an insolvent estate similar to that provided to general notarial bonds. However, a special notarial bond that does not comply with the provisions of the Act will still not provide any preference to its holder above the concurrent creditors of an insolvent debtor. This follows, because s 102 of the Insolvency Act 24 of 1936 remains as it was at the time of the *Cooper* decision and the *Cooper* decision remains the leading authority on this question. See in this regard also Bertelsmann *et al* *Mars* at 438–439 and 491; Natania Locke “Security Granted by a Company Over its Movable Property: The Floating Charge and the General Notarial Bond Compared” (2008) 41 *CILSA* at 143–144.

<sup>100</sup> *Hare v Trustee of Heath* (1884–1885) 3 SC 32 at 35.



#### 5.4.2.2 Alienation of encumbered security objects

The holder of a general notarial bond cannot prevent the company from alienating the security objects.<sup>101</sup> Such disposal leads to the release of the assets from the bond. A company may grant real security over the security objects and that real security will enjoy priority over the general notarial bondholder even when created after the general notarial bond.<sup>102</sup> Movables encumbered by a general notarial bond are available for attachment by judgment creditors.<sup>103</sup> The bondholder cannot follow up the property in the hands of the acquirer, unless the acquirer had actual knowledge of the notarial bond or did not give value in return.<sup>104</sup>

Sacks<sup>105</sup> distinguishes this position from the position relating to the hypothecation of a shop.<sup>106</sup> He argues that the hypothecation of a shop is a distinct device with

<sup>101</sup> Voet *Commentarius* 20.1.14; Sacks 1982 *SALJ* at 615; Scott & Scott *Wille's* at 69; Lubbe in Joubert *et al LAWSA* at 362–363. Execution creditors enjoy preference to the general notarial bondholder, unless the former had actual knowledge of the existence of the bond. See *Meyer v Botha and Hergenröder* (1881–1884) 1 SAR TS 47 at 49.

<sup>102</sup> In *Netherlands Bank of South Africa v Yull's Trustee & The United Building Society* 1914 WLD 133 the Court held that the inclusion of book debts in a general notarial bond, without specific cession *in securitatem debiti*, does not amount to an intention to cede. As such it does not provide real security and will fail against a subsequent cession *in securitatem debiti* of the same book debts where the cession was coupled with notice to the debtors.

<sup>103</sup> *Nedbank Ltd v Norton* 1987 (3) SA 619 (N) at 628D–F.

<sup>104</sup> For authority on the applicability of the doctrine of notice, see *Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd* 2003 (2) SA 253 (SCA) at 257I. The SCA cites *Coaton v Alexander* 1879 Buch 17 and *Cato v Alion and Helps* (1922) 43 NLR 469 as authority. Although authority for the doctrine of notice (*kennisleer*) does come from these cases, a properly constituted pledge did not exist in either of them. In *Coaton* the pledgee voluntarily gave up control and in *Cato* control was never given. The SCA describes the basis of the doctrine of notice as being a species of fraud (*Grant v Stonestreet* 1968 (4) SA 1 (A) at 20B–F) or an intentional interference with contractual relationships. On the latter ground, see NJ van der Merwe “Die Aard en Grondslag van die Sogenaamde Kennisleer in die Suid-Afrikaanse Privaatreg” (1962) 25 *THRHR* 155. Van der Merwe argues that the doctrine of notice is basically a form of delict, which implies that *negligent* interference with the contractual relationship will suffice to vest liability (at 158). In other words, he foresees the possibility of applying the doctrine of notice to the situation where a third party *ought to have known* that there was a prior general notarial bond registered. The current position is, however, that only actual knowledge will suffice. See also *New Klein Koffiefontein Company Ltd v Superintendent of Labourers* 1906 TS 241 at 254; Sacks 1982 *SALJ* at 615–619; Badenhorst *et al Silberberg* at 386; Lubbe in Joubert *et al LAWSA* at 363. Third parties are not deemed to be aware of the existence of a bond. See *Frye's (Pty) Ltd v Ries* 1957 (3) SA 585 (A) at 583E–F.

<sup>105</sup> 1982 *SALJ* at 616–619. Sonnekus 1983 *TSAR* at 245 is of the opinion that a pledge of the enterprise (*ondernemerspandreg*) is impossible in the South African legal system. He continues: “Indien die onderneming, soos dikwels die geval is, self 'n regsobjek is, is dit logies onhoudbaar dat dit ook objek van 'n sekerheidsreg kan wees.” As explained below, I agree that it is not possible to grant security over the enterprise of a legal person in the South African law. However, one should distinguish between the concepts of an ‘enterprise’, sometimes referred to in English law as an ‘undertaking’, and a ‘legal person’. When relating to associations with a profit aim, the latter refers to a company, whether incorporated by special statute or in terms of the Companies Act 61 of 1973, or to a close corporation as incorporated in terms of the Close Corporations Act 69 of 1984. A company or a close corporation is a legal subject in the South African system of subjective rights.

consequences different from that of a general notarial bond. More specifically, it is an essential term of the security agreement of such a hypothec that the security grantor will be free to deal with the encumbered assets in the ordinary course of business. Therefore, a third party who takes the property encumbered by a hypothecation of a shop with knowledge of the existence of the encumbrance, will take it free from the burden. Although this hypothec existed in Roman law and was, to some extent, allowed in Roman-Dutch law,<sup>107</sup> the authorities show that it was a form of special notarial bond and not of a general notarial bond as Sacks seems to imply. Consequently, a hypothecation of a shop, as a form of security over a class of things, will in terms of the then Appellate Division's finding in *Cooper NO v Die Meester*<sup>108</sup> not provide its holders with any preference over the concurrent creditors of the

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The 'enterprise' refers to the collective activities of the business by which it aims to make a profit. It is possible for one company to have more than one enterprise. And so while it is true to say that a company cannot be the object of a right, an enterprise could well be.

<sup>106</sup> Sacks 1982 *SALJ* at 608 describes the hypothecation of a shop as follows: "In terms of this bond, here named the 'business bond' for convenience, the owner of the stock-in-trade and other movable assets of a shop or business hypothecates the assets as security for a debt to the creditor, but, unlike the common general bond, the trader is intended to be free to sell and acquire stock and assets in the ordinary course of business".

<sup>107</sup> D 20.1.34pr: "Where a debtor gave a shop in pledge to his creditor, the question arose whether the transaction was void, or whether it should be held that under the designation of "shop" all of the property contained therein was pledged. And if the party should sell the said merchandise, from time to time, and purchase other goods and place them in said shop, and then should die, could the creditor recover by a hypothecary action everything found there, as the merchandise had been changed, and other articles substituted? The answer was that whatever was found in the shop at the time of the death of the debtor was held to have been pledged." (Translation from SP Scott *The Civil Law: Volume V* (1932) at 130); Voet *Commentarius* 20.1.2: "Special hypothec may be of thing or class. – A special hypothec is one by which individual things or even definite collections of things, such as a flock or herd or a shop, are put under obligation ... When a shop is put under obligation, if the owner of the shop has from time to time sold off wares out of it and gotten others, all things which are later found in the shop are deemed to be part of the pledge." (Translation from Percival Gane *The Selective Voet.*) See also *Francis v Savage and Hill* (1882) 1 SAR TS 33 at 36. Huber *Heedendaegse Rechtsgeleertheit* 2.47.22–23: "There is this difference that the special form [of hypothecation] prevents the alienation of the property, so that, if the debtor sells the thing specially hypothecated, he may be punished as a thief or cheat; but the subject of a general hypothecation may be sold, though subject to its burden, and with the right in the creditor to get it back again. [23] But it should be noted that if a property is hypothecated which consists of many items, and is of such nature that the particular items are always changing, such as a herd of cattle, or, as more commonly happens, a shop full of wares which are sold by retail, then the hypothec covers the whole shop and not the particular items; the secured creditor therefore has no right over the particular items which are sold out of the shop, but only over the shop as a whole; and if owing to the embarrassment of the debtor the stock is not from time to time filled up, but becomes sold out, his hypothec becomes useless, a thing against which he should protect himself." (Translation from Percival Gane *The Jurisprudence of my Time (Heedendaegse Rechtsgeleertheit)* by Ulrich Huber (1636–1694) translated from the 5ed Volume 1 (1936) 345, describing the position in Friesland.) In my opinion subpar 23 indicates an exception to the general rule that objects subject to a special hypothecation could not be alienated.

<sup>108</sup> 1992 (3) SA 60 (A).

insolvent debtor, unless the assets are delivered to the security takers before the debtor is declared insolvent. Registration of such a security in terms of the Security by Means of Movable Property Act 57 of 1993 is impossible, because of the fluctuating nature of the typical contents of a shop, which cannot be described in the manner required by the Act.<sup>109</sup>

However, stock-in-trade and other fluctuating movable assets of a company can form the object of a general notarial bond. I submit that when a third party acquires such assets even with knowledge of the existence of the general notarial bond, it will not affect the validity of such an acquisition. This is because parties to the security agreement will probably not mean to restrict alienation of such assets, because it is the life blood of the company, and a third party should be allowed to assume as much. If such a restriction is intended, I suggest that it must be expressly provided for in the security agreement.<sup>110</sup> Even in such a case, only actual knowledge of the restriction will bar the valid alienation of such assets.

#### 5.4.2.3 Negative pledge clauses

The general notarial bond may contain a so-called negative pledge clause, which is a clause that prohibits the alienation of the security objects.<sup>111</sup> It should be possible to enforce this clause by means of an interdict, if the creditor learns in time that the security objects are about to be alienated.<sup>112</sup> Automatic perfection<sup>113</sup> as a result of the non-compliance with the negative pledge clause is, however, not possible in South African law.<sup>114</sup> The general notarial bond will only be perfected when the creditor takes control of the security objects. Agreement alone will not suffice.

<sup>109</sup> See also Sonnekus 1983 *TSAR* at 247.

<sup>110</sup> See par 5.4.2.3 below.

<sup>111</sup> See par 3.2.6 for the position in English law. See n 104 above for a discussion of the doctrine of notice.

<sup>112</sup> Sacks 1982 *SALJ* at 619 argues that even in absence of such a clause it should be regarded as an implied term of the bond that the security objects should not be alienated.

<sup>113</sup> See also par 5.4.2.4 below.

<sup>114</sup> See ch 3 n 109 for the position in English law.

## 5.4.2.4 Perfecting clauses

The security agreement may stipulate that the bondholder is entitled to take control of the security objects in certain circumstances,<sup>115</sup> thereby creating a real security right. Such a clause is essentially an agreement to constitute a pledge over the encumbered movable property.<sup>116</sup> These clauses are also referred to as ‘perfecting clauses’. If the bond does not contain a perfecting clause, the bondholder does not have a right to take control of the security objects,<sup>117</sup> except by way of an order of execution granted by a court.

If the debtor co-operates in the delivery of the security objects, when the circumstances for delivery as set out in the bond are met, it is unnecessary to obtain a court order to give effect to the rights contained in the bond.<sup>118</sup> If the debtor does not want to comply with the perfecting clause, a court order may be sought to order specific performance.<sup>119</sup>

When the property is delivered to the bondholder in terms of a perfecting clause, the bondholder effectively becomes a pledgee with its consequential rights and preferences.<sup>120</sup> The perfecting clause may be coupled with a summary execution clause (*parate executie* clause), which entails that after he has taken control, the

<sup>115</sup> Johan Roos “The Perfecting of Securities Held under a General Notarial Bond” (1995) 112 *SALJ* at 173 makes the valid point that perfection clauses should clearly state the circumstances under which they will apply, with particular consideration of the business of the debtor. Typically, they will come into operation in the event of a breach of contract, the insolvency of the debtor, and lastly if the business of the debtor changes in a manner that increases the initial commercial risks that the bondholder foresaw.

<sup>116</sup> *Boland Bank Ltd v Vermeulen* 1993 (2) SA 241 (E) at 243F.

<sup>117</sup> *Eerste Nasionale Bank van SA Bpk v Schulenburg* 1992 (2) SA 827 (T) at 828F. In *Boland Bank Bpk v Spies* 1993 (1) SA 402 (T) the *Schulenburg* decision was confirmed and at 403B the Court held that no right to perfection of a notarial bond existed in the common law. A general notarial bond without a perfection clause still gives its holder a preference in the insolvency of the debtor and is therefore not worthless (at 403I). See also *Boland Bank Ltd v Vermeulen* 1993 (2) SA 241 (E) at 244H, where the Court refused to consider perfection an implied term of the bond.

<sup>118</sup> *SAPDC (Trading) Ltd v Immelman* 1989 (3) SA 506 (W) at 508J.

<sup>119</sup> *Boland Bank Ltd v Vermeulen* 1993 (2) SA 241 (E) at 243G. It cannot be contended that taking control pursuant to perfection clauses under these circumstances amounts to self-help, in other words, that it circumvents the authority of the courts. See also Susan Scott “Summary Execution Clauses in Pledge and Perfecting Clauses in Notarial Bonds” (2002) 65 *THRHR* at 660.

<sup>120</sup> *Scott & Scott Wille’s* at 67–68; *Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd* 2003 (2) SA 253 (SCA) at 257H; *Development Bank of Southern Africa Ltd v Van Rensburg* 2002 (5) SA 425 (SCA) at 437A. CFC van der Walt “Aspekte van die Reg Insake Notariële Verbande” (1983) 46 *THRHR* at 335–336 shows that there remains a difference between a perfected general notarial bond and a pledge. Contrary to the position in pledge, a loss of control of the encumbered assets would not leave the bondholder without any security, but he will retain his statutory preference on the insolvency of the debtor.

bondholder will be entitled to sell the goods by public auction, public tender, private treaty or otherwise.<sup>121</sup> The security agreement must make express provision for *parate executie*.<sup>122</sup>

The effectiveness of perfecting clauses as a means to provide the creditor with real security is uncertain.<sup>123</sup> The creditor would usually attempt to take control of the movable assets at a time when a company is either already insolvent or nearing insolvency. This is understandable, because the conversion of the general notarial bond into a pledge would take the movable assets of the company out of its control and would in most cases mean the end of its business operations and its ability to earn income. The bondholder relies foremost on the business' earnings to meet its

<sup>121</sup> The decision in *Findevco (Pty) Ltd v Faceformat SA (Pty) Ltd* 2001 (1) SA 251 (EC), where the Court held in an *obiter dictum* that such clauses are unconstitutional, did not follow precedent and relied on case law where the State was an actor. See Scott 2002 *THRHR* at 661–663. The Court did not draw a distinction to the position relating to immovable property, where *parate executie* has consistently been disallowed. The pledgor may seek the Court's protection if he can show that the pledgee has prejudiced him in his rights during the carrying out of the summary execution agreement (*Osry v Hirsch, Loubser & Co Ltd* 1922 CPD 531 at 547.) The pledgee is considered to be the agent of the pledgor during the summary execution proceedings and cannot deal with the goods as if it were his own. See also *Sakala v Wamambo* 1991 (4) SA 144 (ZHC) at 148, where the Court reversed the sale of a motor vehicle at a gross under-value, finding that the transaction was not in the best interests of the applicant-pledgor. *Findevco* was followed in *Senwes Ltd v Muller* 2002 (4) SA 134 (T). The Court based its findings on the same precedent as *Findevco* and consequently the same criticism applies. The issue was put to rest in *Bock v Duburoro Investments (Pty) Ltd* 2004 (2) SA 242 (SCA) at 250B–C and *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 (5) SA 248 (SCA) at 256B, where the SCA confirmed the validity of *parate executie* clauses. See also *SA Bank of Athens Ltd v Van Zyl* 2005 (5) SA 93 (SCA) at 101E; JC Sonnekus “Onverwagte Raakpunte tussen Menseregte en Saaklike Sekerheidsregte?” (2002) 39 *Tijdschrift voor Privaatrecht* 1 at 10–11; Samantha Cook & Grant Quixley “Parate Executie Clauses: Is the Debate Dead?” (2004) 121 *SALJ* 719; Lee Steyn “Perfection Clauses, Summary Execution (*Parate Executie*) Clauses, Forfeiture Clauses (*Pacta Commossoria*) and Conditional Sales in Pledge Agreements and Notarial Bonds: The Position Clarified” 2004 (25) *Obiter* 443; Susan Scott “A Private-Law Dinosaur's Evaluation of Summary Execution Clauses in Light of the Constitution” (2007) 70 *THRHR* 289; Badenhorst *et al Silberberg* at 390.

<sup>122</sup> *Mercantile Bank of India Ltd v Davis* 1947 (2) SA 723 (C) at 736–737; *Candid Electronics (Pty) Ltd v Merchandise Buying Syndicate (Pty) Ltd* 1992 (2) SA (C) 459 at 463D.

<sup>123</sup> See, for instance, JC Sonnekus “Perfektering van Algemene Notariële Verbande en Loon vir Laatslapers” (2002) 3 *TSAR* 567 at 568; Sonnekus 2002 *TPR* at 4. It should be remembered that the bondholder will effectively take control of the business of the debtor when it takes control of the movable property encumbered by the general notarial bond. In *Barclays National Bank Ltd v Natal Fire Extinguishers Manufacturers Co (Pty) Ltd* 1982 (4) SA 650 (D) at 658C–H the Court stated that the granting of specific performance of a perfection clause that would lead to this result, would “operate unreasonably hardly” on the company and would be “inequitable under all circumstances” to its other creditors. These observations must be considered as *obiter*, because the Court based its final decision on other considerations. The Court also did not consider that a pledgee is in fact an agent of the pledgor. See also Roos 1995 *SALJ* at 175. Taking control of a business as security has subsequently been allowed by the SCA. See *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 (5) SA 248 (SCA) at 261C–E.

obligations and only secondarily on its security. It is therefore in the bondholder's interest to postpone perfection until as late as possible.

Converting the general notarial bond into a pledge would be considered a disposition in terms of the Insolvency Act.<sup>124</sup> If a company is liquidated shortly after the perfecting of the general notarial bond, the liquidator may attempt to have it set aside as a voidable preference,<sup>125</sup> or alternatively, as an undue preference.<sup>126</sup>

However, two recent Supreme Court of Appeal decisions seem to have given approval to the perfecting of a general notarial bond, even though delivery was made only hours before the application for the provisional liquidation of the company was heard. This greatly enhances the importance of such clauses in general notarial bonds, as well as the usefulness of this form of security for those creditors alert enough to be the first to perfect.

The first of these decisions was *Development Bank of Southern Africa Ltd v Van Rensburg*.<sup>127</sup> Here the Development Bank brought an urgent application for an interim order that it may take control of the debtor's (Serious Mills (Pty) Ltd) movable property. By pure chance it came to the Development Bank's attention that some of

<sup>124</sup> 24 of 1936. Section 340 of the Companies Act 61 of 1973 provides as follows: "Every disposition by a company of its property which, if made by an individual, could, for any reason, be set aside in the event of his insolvency, may, if made by a company, be set aside in the event of the company being wound up and unable to pay all its debts, and the provisions of the law relating to insolvency shall *mutatis mutandis* be applied to any such disposition." Section 2 of the Insolvency Act 24 of 1936 states: "[Disposition] means any transfer or abandonment of rights to property and includes a sale, lease, mortgage, pledge, delivery, payment, release, compromise, donation or any contract therefore, but does not include a disposition in compliance with an order of the court." See further n 125 and n 126 below and par 8.2.

<sup>125</sup> Section 29(1) of the Insolvency Act 24 of 1936: "Every disposition of his property made by a debtor not more than six months before the sequestration of his estate ... which has had the effect of preferring one of his creditors above another, may be set aside by the Court if immediately after the making of such disposition the liabilities of the debtor exceeded the value of his assets, unless the person in whose favour the disposition was made proves that the disposition was made in the ordinary course of business and that it was not intended thereby to prefer one creditor above another." In *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1016J–1017A the Court held that the relevant time to determine whether a disposition by means of a general notarial bond took place is the time when the bondholder takes delivery of the assets. In this case the majority decision held that, with due regard to all the facts before the Court, the debtor's main intention was not to prefer the creditor, but to comply with the terms of the bond agreement (at 1034E and 1039G–H). The perfection was accordingly upheld. See also David Burdette & André Boraine "Crucial Elements of Voidable Dispositions under Scrutiny" 2000 *Obiter* 476 for a discussion of the *Cooper* decision. For a detailed discussion of s 29, see par 8.2.2.

<sup>126</sup> Section 30(1) of the Insolvency Act 24 of 1936: "If a debtor made a disposition of his property at a time when his liabilities exceeded his assets, with the intention of preferring one of his creditors above another, and his estate is thereafter sequestrated, the court may set aside the disposition." For a more detailed discussion of s 30, see par 8.2.3.

<sup>127</sup> 2002 (5) SA 425 (SCA). See also the discussion by Sonnekus 2002 *TSAR* 567; Badenhorst *et al Silberberg* at 388–390.

the other creditors of the debtor would launch an application for its liquidation the following day. In fact, were it not that the Master was absent from his office on 9 September, the application for liquidation may have been heard on that day. The interim order was granted at 22:00 on 9 September and the provisional order for the liquidation of Serious Mills was granted during the afternoon of 10 September. Control of Serious Mills' movable property was taken by the Deputy Sheriff during the course of the morning of 10 September. On the extended return day the provisional order for attachment was discharged. The appeal was against that decision.

No attempt was made by the Development Bank to obtain delivery of the movable property from Serious Mills first. Usually, specific performance of the perfecting clause is only requested if the debtor does not give its co-operation. The co-operation of the debtor in this case would not have served the Development Bank, because it would then fall under the definition of 'disposition' in terms of the Insolvency Act 24 of 1936.<sup>128</sup> If the perfection was done in terms of a court order, it would not be considered a disposition. This was not the first time that an attempt had been made to use a court order for this purpose.<sup>129</sup>

The Court *a quo* held that the provisional winding-up order had to take precedence over the order for attachment and that the rule had to be discharged in the light of

<sup>128</sup> See n 124 above.

<sup>129</sup> See *SAPDC (Trading) Ltd v Immelman* 1989 (3) SA 506 (W) at 509G–I: “What applicant really seeks is an order which precludes any future finding that delivery constitutes an assailable delivery. Thirdly, the Court should not lend itself to such a scheme to the detriment of the general body of present and future creditors”. At 510B: “applicant has a right to delivery but not a right to delivery in compliance with a Court order”. At 510C: “However, if there is an arguable case to the effect that the delivery had features which make it impeachable, it serves as a reason why the Court should not make the order and thus pre-empt an arguable case without even hearing the other interested parties”. This case was not referred to in *Development Bank* or in *Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd* 2003 (2) SA 253 (SCA). The *SAPDC* decision was affirmed in a minority judgement by the SCA to the extent that when delivery preceded the court order, it could not be regarded as a disposition “in compliance with an order of the Court” in terms of s 2 of the Insolvency Act 24 of 1936. See *Cooper NO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1017I. Though the *SAPDC* decision is not binding on the SCA, I submit that the reasoning of Flemming J is sound and should have been considered. The perfection of the bond under these circumstances ought to be a disposition in terms of the Insolvency Act 24 of 1936. Whether the disposition will be impeachable in terms of the relevant sections of that Act depends on the circumstances. However, in *Cooper NO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1032D–F the SCA held that if the debtor's primary intention was to comply with a perfection clause in the security agreement, and not to prefer the specific creditor, the necessary intention to grant an order in terms of s 29 of the Insolvency Act 24 of 1936 is not present. The SCA further held that perfection of a general notarial bond falls in the ordinary course of business (at 1034F–1035F). The effect of this decision is that a creditor who perfected a general notarial bond close to the liquidation of the debtor will normally be able to rely on the defences set out in s 29 of the Act.

*International Shipping Co (Pty) Ltd v Affinity (Pty) Ltd*<sup>130</sup> and *Trisilino v De Vries*.<sup>131</sup>

The Supreme Court of Appeal overturned the decision of the Court *a quo* and the provisional order for attachment was confirmed.<sup>132</sup>

On appeal the majority held that reliance on the cases cited above were misplaced. The Court distinguished *International Shipping Co* based on the fact that the winding-up order in that case was granted before the rule *nisi* and the interim order for attachment were granted.<sup>133</sup> The Court rejected the finding in *Trisilino* that the effect of the interim order was to preserve the applicant's rights pending the return day.<sup>134</sup>

The majority held that the Development Bank was entitled, immediately before the winding-up of Serious Mills, to take control of the movable property and that no reasons were advanced why the provisional order should not have been granted *on that date*. In other words, the Court held that it may not consider new considerations that had arisen after the interim order and the rule *nisi* had been issued, such as the consequent winding-up order. The Court held that the Development Bank took valid control of the movable property and became a pledgee of Serious Mills.<sup>135</sup>

In my opinion the order should not have been confirmed under circumstances of imminent liquidation. Surely the abuse of the court's order so that such a late disposition cannot be avoided by the liquidators of a company must be an adequate reason why such an order should not have been granted. Whether or not the liquidator will be successful with an attempt to impeach the perfection of the bond depends on the circumstances of each case,<sup>136</sup> but at the very least it affords the court the opportunity to consider the interests of the creditors of the company generally, but

<sup>130</sup> 1983 (1) SA 79 (C).

<sup>131</sup> 1994 (4) SA 514 (O).

<sup>132</sup> From the facts it emerges that the Agricultural Bank was, in fact, originally Serious Mills' creditor. The Agricultural Bank ceded its rights against Serious Mills to the Development Bank as security. This purported cession raises substantial questions of its own, which are discussed below. I shall assume for now that the cession was valid.

<sup>133</sup> At 435B–C.

<sup>134</sup> At 436A and 436H–437A.

<sup>135</sup> Whether or not the Development Bank took control of the assets in a manner that would perfect a pledge was not argued before the Court. It does seem, however, that the sheriff never passed control to the Bank. See P O'Brien & A Boraine "Legal Issues Relevant in the Administration of Insolvent Estates and Winding-up of Corporate Entities" (2002) 1 *South African Insolvency Law Review* at 104–105 and 109.

<sup>136</sup> See n 129 above and par 8.2.2.



specifically the interests of competing general notarial bondholders. It seems that the Court was not made aware of the implications of its confirmation of the rule *nisi*.

The minority judgment delivered by Nienaber JA appreciates the true implications of confirmation of the interim order. This judgment found *International Shipping Co* and *Trisilino* in point and helpful.<sup>137</sup> With regard to *International Shipping Co* Nienaber JA recognised that there are differences in fact between the two cases, but he agreed with the finding by that court<sup>138</sup> that a rule *nisi* did not have finite and definite effect: “An interim order is by its very nature both temporary and provisional; its purpose is to preserve the *status quo* pending the return day.”<sup>139</sup> In other words, a court may consider circumstances that arose after the interim order and the rule *nisi* had been issued in its decision whether or not to confirm the rule.<sup>140</sup>

The minority judgment recognised that the reasons of the Court in *International Shipping Co* for not confirming the provisional order were relevant to the case before it, namely that the provisional liquidators of the company should be allowed to administer the estate of the company to the benefit of all creditors and that there were no reasons to allow the applicant to place himself in a better position of priority at that stage. Furthermore, Nienaber JA agreed with *Trisilino* that a provisional order of sequestration granted before the return date of the rule *nisi* should defeat the interim order of attachment, causing the rule to be discharged.<sup>141</sup> Nienaber JA also approved the decision of the Court *a quo* in *Chesterfin (Pty) Ltd v Contract Forwarding (Pty) Ltd*,<sup>142</sup> which came to the same conclusion.<sup>143</sup>

Then followed the decision of the Supreme Court of Appeal, this time a full bench, in *Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd*.<sup>144</sup> The debtor in this case

<sup>137</sup> At 441H.

<sup>138</sup> At 86H.

<sup>139</sup> At 443I.

<sup>140</sup> See also O’ Brien & Boraine 2002 *SAILR* at 109–110. These authors agree with the minority judgment.

<sup>141</sup> At 446B.

<sup>142</sup> 2002 (1) SA 155 (T).

<sup>143</sup> At 169F.

<sup>144</sup> 2003 (2) SA 253 (SCA). The following remark by O’ Brien & Boraine 2002 *SAILR* at 111 referring to *Development Bank* seems ironic as one reads this judgment: “It is unlikely that the particular issue which arose in this matter will again come before the Supreme Court of Appeal any time soon. It is hoped that the opportunity will arise to overrule the majority decision herein. It is submitted that the majority judgment creates an untenable situation.”

was Eurotile. Contract Forwarding, a general notarial bondholder, obtained an interim order for attachment of Eurotile's movable assets and a rule *nisi* on 11 April 2001. The keys of the business premises of Eurotile were handed to Contract Forwarding by the sheriff on the same day. Before the return date of the rule *nisi*, Eurotile was placed under provisional liquidation. The return date was subsequently postponed several times, to the extent that at the time of the eventual hearing the liquidation order had been made final. The appointed liquidators had already sold the movable property in question and kept the proceeds in a separate account until the Court's final determination.

Chesterfin was another creditor and also a general notarial bondholder of Eurotile. Its general notarial bond was registered prior to that of Contract Forwarding and its claim would rank prior to that of Contract Forwarding in Eurotile's insolvency, if both bonds were not perfected. There were two general notarial bonds in favour of Eurotile's bank ranking above Chesterfin's claim. Then there was a general notarial bond in favour of Metro International Ltd, which was registered after Chesterfin's bond, but before Contract Forwarding's bond. In other words, there were four general notarial bonds that would rank higher than Contract Forwarding's bond if the Court found that its interim order of attachment did not perfect the bond.

Moreover, the general notarial bond in favour of Contract Forwarding was only registered on 19 October 2000, less than six months before the interim order was granted and only six months before the date of the provisional liquidation order (20 April 2001). In these circumstances a liquidator could even argue that the unperfected general notarial bond is a voidable preference.<sup>145</sup>

Chesterfin's bond contained a negative pledge clause and an express clause allowing for the alienation of stock-in-trade in the ordinary course of business.<sup>146</sup> Chesterfin's argument was at least partially that Contract Forwarding should be considered to have constructive notice of the existence of its prior bond and its terms.<sup>147</sup> However, its arguments were mostly based on the inequity of allowing Contract Forwarding to obtain the position of a secured creditor at such a late stage

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<sup>145</sup> See n 125 above and the discussion in par 8.2.2.

<sup>146</sup> See the discussion of the hypothecation of a shop in par 5.4.2.2 above.

<sup>147</sup> Contract Forwarding argued that it did not need to make enquiries in this regard and could rely on the word of the managing director of Eurotile that there were no other bondholders.

before the liquidation of the company and in priority over other general notarial bondholders whose bonds were registered earlier.

In the Court *a quo* it was found that the authorisation given to Contract Forwarding to take control of the movable property was only provisional and was therefore subject to reconsideration on the return day. A main factor in this finding was that the other notarial bondholders were not present at the urgent application. *Dicta* to this effect from previous decisions were approved and followed.<sup>148</sup>

In its reconsideration of the provisional order, the Court *a quo* took into account that there were three other bondholders as well as the intervening liquidation of Eurotile. The Court decided that it was not persuaded that compelling reasons existed to use its discretion in favour of Contract Forwarding and allow a disposition after liquidation prejudicing the other creditors of the liquidated Eurotile. It would confer secure status on an otherwise unsecured claim.<sup>149</sup> The arguments surrounding notice became superfluous and were not considered. The Court set aside the interim order and discharged the rule *nisi*.

The Court *a quo*'s decision was delivered before the Supreme Court of Appeal's decision in *Development Bank*.<sup>150</sup> However, by the time the matter reached the appeal stage, *Development Bank* had been decided and had to be considered.

The Supreme Court of Appeal overturned the decision of the Court *a quo*, and confirmed the interim order for attachment. The first finding of the Court was that the doctrine of constructive notice was not applicable to registered notarial bonds. In other words, a third party was not deemed to be aware of the existence of other notarial bonds.<sup>151</sup>

The Court then stated that the Court *a quo* was incorrect in finding that the previous bondholders enjoyed precedence over later bondholders.<sup>152</sup> The Court failed

<sup>148</sup> *International Shipping Co (Pty) Ltd v Affinity (Pty) Ltd* 1983 (1) SA 79 (C) at 85H–87E and *Chrome Circuit Audiotronics (Pty) Ltd v Recoton European Holdings Inc* 2000 (2) SA 188 (W) at 190B–D where it is stated: “The Uniform Rules of Court, recognising the paramount importance of the *audi alteram partem* principle in our legal system, provide that: ‘A person against whom an order was granted in his absence in an urgent application may by notice set down the matter for reconsideration of the matter.’”

<sup>149</sup> At 169F–H.

<sup>150</sup> *Development Bank of Southern Africa Ltd v Van Rensburg* 2002 (5) SA 425 (SCA).

<sup>151</sup> In *Frye's (Pty) Ltd v Ries* 1957 (3) SA 585 (A) at 583E–F this was found to be the position relating to the ownership of land and other real rights. The Court relied on this authority for its finding in the *Chesterfin* decision.

<sup>152</sup> At 258B.

to consider that the principle of *prior tempore potior iure* applied to notarial bonds in terms of the common law.<sup>153</sup> The Court went on to regard the general notarial bond as already perfected and then stated that “real rights are stronger than personal rights”. This was really what the Court still had to decide, namely whether it should confer the status of pledgee on Contract Forwarding. Only if that question was answered affirmatively would the principle as stated apply. Then the Court stated that a pledge was established by means of taking possession and not by means of an agreement to pledge.<sup>154</sup> The Court failed to distinguish between an agreement to pledge, the so-called real agreement,<sup>155</sup> and delivery in order to perfect a pledge.

The Court’s most radical finding was that general notarial bonds containing perfecting clauses may be perfected on a first-come-first-served basis, regardless of other previously registered general notarial bonds.<sup>156</sup> The only exception would be if the later bondholder had actual knowledge of the existence of a previously registered general notarial bond.<sup>157</sup> The bondholder would then not be allowed to perfect the general notarial bond. A negative pledge clause<sup>158</sup> in the bond would make no difference in this regard.

<sup>153</sup> *Hare v Trustee of Heath* (1884–1885) 3 SC 32 at 34.

<sup>154</sup> At 258C.

<sup>155</sup> In Roman law the transfer of a real right was done by way of a *contractus re*. See Max Kaser & FBJ Wubbe *Romeins Privaatrecht* 2 ed (1971) at 141. The real agreement transferring a real right stands separately from the agreement from which the obligation flows (the obligatory agreement) (Friedrich Karl Von Savigny *System des heutigen römischen Rechts* (1840) at 312–313. See also I Raghoebarsingh *Overdracht van Roerende Zaken* (1964) at 91). This distinction between the transfer agreement and the obligatory agreement is characteristic of legal systems, such as South Africa, that follow an abstract system of transfer of rights (*Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 398 and 411; *Trust Bank van Afrika Bpk v Western Bank Bpk* 1978 (4) SA 281 (A) at 301H–302A; *Krapohl v Oranje Koöperasie Bpk* 1990 (3) SA 848 (A) at 864E–G). In such systems the real agreement, coupled with adequate publicity of the transfer (delivery in the case of pledge), is adequate to transfer the right, regardless of any deficiencies in the obligatory agreement. The real agreement entails the expression by the transferor of the will to transfer the real right to the transferee and the acceptance by the transferee of the real right (Raghoebarsingh *Overdracht* at 1–2). The real agreement must still be valid at the time of delivery of the thing for transfer of the real right to occur (*Weeks v Amalgamated Agencies Ltd* 1920 AD at 218). The distinction between the transfer agreement and the obligatory agreement must be made with regard to the transfer of all proprietary rights, including claims. See Susan Scott “Sessie en die Saaklike Ooreenkoms” 1979 *TSAR* 48 at 51; Susan Scott *The Law of Cession* 2 ed (1991) at 59–69; Badenhorst *et al Silberberg* at 74–76; PJW Schutte “Die Grondslae vir von Savigny se Teorie Betreffende die Saaklike Ooreenkoms” 2008 *TSAR* at 66. See further pars 7.2 and 7.2.1.

<sup>156</sup> It based this conclusion on the principle that the law protects those who are vigilant and not those that sleep (*vigilantibus non dormientibus iura subveniunt*) and preferred this to the Court *a quo*’s reliance on what is just and equitable.

<sup>157</sup> On the doctrine of notice, see n 104 above.

<sup>158</sup> See the discussion in par 5.4.2.3 above.

The Court interpreted the decision of the Court *a quo* as finding that to confirm the interim order would be a disposition, which was prohibited by section 341(2) of the Companies Act.<sup>159</sup> This is not how I understand the decision of the Court *a quo*. My understanding is that section 341(2) grants the court discretion to allow a disposition after commencement of a winding-up, but that the Court in this situation thought it unjust to use its discretion *in terms of section 341(2)* in favour of Contract Forwarding. The Court's consideration of section 341(2) is a result of its finding that the interim order did not perfect the general notarial bond into a pledge, thereby converting the bondholder into the position of a pledgee, and that it had the discretion to overturn the interim order.

The Supreme Court of Appeal's remark that the Court *a quo* must have confused sections 348 and 359(1)(b)<sup>160</sup> is not only unnecessary, taking into account its later findings, but also in my opinion incorrect. The "later findings" I refer to is that it considered Contract Forwarding's possession following the interim order as valid for perfecting the pledge. It held that it could only refuse to confirm the order if the order had, for instance, not been granted properly due to an irregularity in the bond or because there was no outstanding debt.<sup>161</sup>

The Court rejected the argument that the interim order of attachment had a mere holding effect.<sup>162</sup> It also rejected the argument that it had a discretion to refuse specific performance of the perfecting clause in these circumstances. The Court stated that it could only exercise this discretion if the creditor had another remedy such as damages, but a claim for damages, it held, could not replace *a claim for real security*.<sup>163</sup> The Court continued:<sup>164</sup>

In the absence of a conflict with the Bill of Rights or a rule to the contrary, a court may not under the guise of the exercise of a discretion have regard to what is fair and equitable in that particular court's view and so dispossess someone of a substantive right.

<sup>159</sup> 61 of 1973. The section reads as follows: "Every disposition of its property (including rights of action) by any company being wound-up and unable to pay its debts made after the commencement of the winding-up, shall be void unless the Court otherwise orders." The commencement of winding-up is the time of the presentation to the Court of the application for winding-up (s 348).

<sup>160</sup> At 258G–H. Section 359(1)(b) provides that after the order for winding-up has been given, any order for attachment against the estate or assets of the company will be void.

<sup>161</sup> At 259B.

<sup>162</sup> At 259I.

<sup>163</sup> At 260B–C.

<sup>164</sup> At 260D.

I submit that the Court's view does not properly consider the interests of the other bondholders, nor the practicalities that surround the perfection of these bonds. Only one creditor can perfect a general notarial bond, because the requirement of physical control makes it impossible for more than one person to be a pledgee. It is probable that all the general notarial bonds in this case contained perfecting clauses. However, the Court did not consider this, nor did it consider anywhere in its judgment the fact that its decision would bar the liquidators of Eurotile to void the preference, because the disposition was done in terms of a court order. The Court's failure to see this consequence is manifest where it stated:<sup>165</sup>

The order did not give Contract Forwarding possession but permitted it to take possession legally. *The position would have been no different had Eurotile handed the goods to Contract Forwarding willingly* (my emphasis).

I submit that this is the “manifest oversight or misunderstanding” that the Court, by its own admission, may have used rather to follow the judgment of Nienaber JA than that of the majority in *Development Bank*.<sup>166</sup> The Court should have heeded its own previous statement on the exercise of its discretion to order specific performance, when it stated:<sup>167</sup>

It [the discretion] is aimed at preventing an injustice – for cases do arise where justice demands that a plaintiff be denied his right to performance – and the basic principle thus is that the order which the Court makes should not produce an unjust result ... Another principle is that the remedy of specific performance should always be granted or withheld in accordance with legal and public policy.

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<sup>165</sup> At 259C.

<sup>166</sup> At 259 F–H where the Court refuses to follow Nienaber JA's minority judgment based on the *stare decisis* principle, it refers to the following quote from *Bloemfontein Town Council v Richter* 1938 AD 195 at 232 with approval: “The ordinary rule is that this Court is bound by its own decisions and unless a decision has been arrived at on some manifest oversight or misunderstanding, that is that there has been something in the nature of a palpable mistake, a subsequently constituted Court has no right to prefer its own reasoning to that of its predecessors .”

<sup>167</sup> *Benson v SA Mutual Life Assurance Society* 1986 (1) SA 776 (A) at 783D. See also *Haynes v Kingwilliamstown Municipality* 1951 (2) SA 371 (A) at 378H–379A; Roos 1995 *SALJ* at 178–179. In *Barclays National Bank Ltd v Natal Fire Extinguishers Manufacturers Co (Pty) Ltd* 1982 (4) SA 650 (D) at 656D–G the Court mentioned the argument that each creditor must look after its own interests and initiate liquidation if needs be. However, only one general notarial bond can be perfected, which turns the bond into real security. In most cases there will be little incentive for unsecured creditors to initiate liquidation after a general notarial bond had been perfected.

Perfection will only be valid if the security objects are delivered to the bondholder before the provisional order of liquidation of the debtor.<sup>168</sup> This principle remains notwithstanding the two Supreme Court of Appeal cases discussed above.

#### 5.4.2.4.1 *Legislative intervention required*

I submit that the two decisions by the Supreme Court of Appeal discussed above reveal certain underlying problems with the use of general notarial bonds in South African law. The current legal position is that the first general notarial bondholder that perfects his security will have a secured claim against the estate of the debtor. The other general notarial bondholders will always only have a preference over the unsecured creditors of the debtor's insolvent estate, because only one person can take physical control of the security objects. This is the position regardless of the fact that the general notarial bonds themselves might have been created before the one that was perfected.

Bondholders cannot effectively strengthen their position by means of contractual clauses to prevent later security over the assets, because later bondholders are not deemed to be aware of such clauses. It further makes no difference whether the other bondholders were only fractionally later than the successful bondholder in their attempts to perfect. Nor will the court refuse to confirm an interim order for attachment if the estate of the debtor is liquidated in the meantime.

The most recent pronouncements of the Supreme Court of Appeal on these matters seem to indicate that the court wants to uphold the secured status of a perfected general notarial bond as far as possible.<sup>169</sup> This is to be welcomed, considering the frequency with which general notarial bonds are used and the fact that it is very difficult to perfect them before the impending insolvency of the debtor.

However, I submit that the legislature will have to consider intervention to remedy the inequities that result from the physical impossibility of more than one bondholder to acquire control of the encumbered assets. One possibility might be to introduce a form of receivership of the movable property of the debtor, which is activated on an application by any bondholder to perfect his security.<sup>170</sup> The receiver will take control

<sup>168</sup> *Trisilino v De Vries* 1994 (4) SA 514 (O) at 518I–J.

<sup>169</sup> See also *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) and my comments in n 129.

<sup>170</sup> On receivership in English law, see par 3.2.4.

of the assets and will manage the process on behalf of the general notarial bondholders. The receiver will owe the debtor the same duties as a pledgee.<sup>171</sup> Secured status will then be granted to all general notarial bondholders on the appointment of the receiver and priority will be determined by the order of the registration of their bonds. All general notarial bonds must be granted the ability to be perfected in this manner and perfecting clauses should no longer be required.

I submit that bondholders should not be allowed to alter their priority based solely on chance. If creditors are not satisfied with where they will lie in order of preference if the proposal above is implemented, they ought to refuse to extend credit. It will be unnecessary to include restrictive clauses to prevent the further extension of general notarial bonds over the assets, because such later bondholders will not be able to better their position in relation to the first bondholder by way of perfection. The position of the general notarial bondholders in relation to other secured creditors will remain unchanged, as will the power of the debtor to grant further security over the encumbered assets. The order of priority must remain intact during the subsequent liquidation of the debtor.

I submit that such a system will lead to a far more satisfactory position for general notarial bondholders, although it will inevitably mean that there will be fewer assets available for distribution to preferent and unsecured creditors of the insolvent debtor. In the current system the amount that will be secured by a perfected general notarial bond will always be limited to one bondholder's claim.

It might also be argued that there will be no motivation for later general notarial bondholders to monitor the affairs of the debtor effectively, because their order of priority is fixed on the date of the registration of the general notarial bond. They will inevitably benefit from the diligence of the earlier bondholders. However, in my opinion this is a satisfactory position. Since the earlier bondholder stands to gain more from his attentiveness to the affairs of the debtor, he should carry a greater burden to monitor the debtor. Of course, the reverse is also true: the earlier bondholder stands to gain from the diligence of later bondholders who apply for perfection regardless of their lesser priority.

One negative aspect of the proposed system is that a general notarial bondholder will not be in a position to grant the debtor more time to overcome financial

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<sup>171</sup> See n 121 and 123.



difficulties if any of the other bondholders do not agree. However, this is also a problem under the current system. I submit that the appointment of a receiver might actually alleviate this problem. The receiver could report to the bondholders on the possibility of the debtor managing its way out of financial difficulty. If approved, the debtor could continue with its business operations, with the restrictions agreed upon between it and the receiver. If the debtor manages to overcome its difficulties, control of the assets can be returned. If the debtor cannot overcome its difficulties, the receiver could apply for the debtor's winding-up due to inability to pay its debts.

### 5.4.3 Security by means of claims

The legislature excluded claims as possible security objects of a special notarial bond in terms of the Security by Means of Movable Property Act.<sup>172</sup> Section 1 of the Act specifies that a special notarial bond may only be registered over corporeal movable property specified and described in the bond in a manner that renders it readily recognisable. Personal rights are not corporeal movable property and therefore fall outside this definition.<sup>173</sup>

However, in practice extensive use is made of claims as security. More importantly, the Companies Act specifically mentions the use of claims as a possible means of security for debentures.<sup>174</sup>

In the current South African system of subjective rights, a claim cannot be the object of real security, because it is not a thing.<sup>175</sup> However, a claim is an asset and has

<sup>172</sup> 57 of 1993.

<sup>173</sup> The exception is shares, which are described in s 91 of the Companies Act 61 of 1973 as follows: "The shares or other interest which any member has in a company shall be *movable property*, transferable in the manner provided by this Act and the articles of the company (my emphasis)". However, shares do not need to be identified by a number if they rank *pari passu* for all purposes with other shares of that class (s 95(1)(a) of the Companies Act 61 of 1973). Furthermore, I agree with the view expressed by Elias Leos "Quasi-Usufruct and Shares: Some Possible Approaches" (2006) 123 *SALJ* at 137 that shares listed on a securities exchange have a fungible character, because one share is interchangeable with another. Therefore, it is questionable whether shares could be sufficiently described to adhere to the requirements of the Security by Means of Movable Property Act 57 of 1993.

<sup>174</sup> Section 117(1)(c), where the use of 'incorporeal rights' as security for debentures is allowed.

<sup>175</sup> Our system of subjective rights is based on the work of WA Joubert *Grondslae van die Persoonlikheidsreg* (1953) and his later publication "Die Realiteit van die Subjektiewe Reg en die Betekenis van 'n Realistiese Begrip Daarvan vir die Privaatreg" (1958) 21 *THRHR* 12 and 98. This system classifies subjective rights according to the nature of their objects. According to this classification the object of a real right (such as pledge) is always a thing. By Joubert's own admission, incorporeal property as a possible object of a real right is left out of the classification because it does not fit into the system. He mentions the pledge of personal rights as an example of impossibility in the system (*Grondslae* at 120 and 122; 1958 *THRHR* at 113). I argued elsewhere

an intrinsic value that can be realised.<sup>176</sup> Often it is the only asset available for security purposes.

The general notarial bond as a method of providing security by means of claims was discussed above. Security by means of claims can be created in two further ways,<sup>177</sup> namely (1) a pledge of claims or (2) a fiduciary security cession.<sup>178</sup>

#### 5.4.3.1 Pledge of claims

When a pledge of claims is used in the context of a securitisation scheme, the SPV will be the pledgor and the trustee for debenture-holders will be the pledgee. In terms of this construction, the claims remain in the estate of the pledgor. Consequently, the pledgee will not be able to cede the claims given as security to third parties.

In accordance with the position relating to a pledge of things, a pledge of claims is also of an accessory nature.<sup>179</sup> This means that the real security right is dependent on the existence of a principal debt for its creation and continued existence. If the principal debt is settled, the right of pledge will automatically cease to exist. The extent of the encumbrance on the claims in terms of the pledge of claims is determined by reference to the value of the principal debt. This further implies that a

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that the exclusion of the possibility of a pledge of personal rights must be seen as an indication that the current system of subjective rights ought to be adjusted: see Strydom *Die Akessoriteitsbeginsel* at 126–127; Natania Locke “Aksessoriteit en Sekerheidstelling deur Middel van Vorderingsregte” 2001 *TSAR* at 483. See further the comments of Gerhard Lubbe “Die Verpanding van Vorderingsregte en die Regsdogmatiek: *Quo Vadis?*” (1991) 2 *Stell LR* at 141–144.

<sup>176</sup> Voet *Commentarius* 20.3.1 as translated by Gane *The Selective Voet*: “Gaius laid down a rule as to the putting of things under the obligation of pledge in the passage cited below when he said that: ‘That which admits of purchase and sale can admit also of hypothecation’ (D XX 1 9 1) For the rest things can be given in pledge which are movable or immovable, corporeal and incorporeal, such as accounts or actions, so that the creditor to whom an account had been put under obligation has beneficial actions.”

<sup>177</sup> On cession in *securitatem debiti* in general, see Scott *Cession* at 231–252; Susan Scott “Evaluation of Security by Means of Claims: Problems and Possible Solutions. Section A: Problems” (1997) 60 *THRHR* 179; Susan Scott “Evaluation of Security by Means of Claims: Problems and Possible Solutions. Section B: Possible Solutions” (1997) 60 *THRHR* 434; Susan Scott “Evaluation of Security by Means of Claims: Problems and Possible Solutions. Section C: Codification of the Law of Cession” (1997) 60 *THRHR* 633 and (1998) 61 *THRHR* 88.

<sup>178</sup> Too often security agreements are drafted in such a way that both the pledge construction and fiduciary security cession of claims can apply to the transaction. This leads to uncertainty about the legal consequences of the agreement. It may also lead to a finding that the agreement is void for vagueness. See Susan Scott “Algehele Sekerheidsessie” (1988) 51 *THRHR* at 450. The consequences of each interpretation of security by means of claims are reasonably settled, although this is truer for pledge of claims than for fiduciary security cession. Parties ought to state their intention clearly. See also Scott *Cession* at 235 and 252.

<sup>179</sup> See Locke 2001 *TSAR* at 486 *et seq.* See also Scott *Cession* at 238–239; Scott 1997 *THRHR* at 182–183 and 448.

security grantor may offer the same claims as security to several creditors, as long as the value of the claims is sufficient to cover all the debts.

By analogy to the position relating to pledge, it is essential that a pledge of claims be sufficiently publicised. Case law supports the position that cession of incorporeals is the equivalent of delivery of corporeals.<sup>180</sup> Scott<sup>181</sup> criticises this view with regard to a pledge of claims. In a pledge of claims only the power to realise the claim and not the claim itself is transferred. Whereas delivery of a corporeal security object is evident for third parties, cession is not and as such does not inform third parties of the legal position. She argues that the best method of publicity is to notify the debtor of the existence of the pledge.<sup>182</sup> She adds that if notice to debtors were to be confirmed as a requirement for the proper constitution of a pledge of claims, many lenders and borrowers would not find it suitable as a form of security.

This would definitely be the case in securitisation, where the debtors might not be familiar with the concept of securitisation. During securitisation the claims will be ceded twice: first, in terms of a sale agreement between the originator and the SPV<sup>183</sup> and, second, in terms of security agreement between the SPV and the security SPV or trustee for debenture-holders.<sup>184</sup> Notice is not a requirement for the cession of the claims to the SPV and will usually not be given. If the debtors are informed of the pledge of claims to the security SPV or trustee for debenture-holders without even knowing about the securitisation transaction, it is foreseeable that they may be

<sup>180</sup> *Smith v Farelly's Trustee* 1904 TS 949 at 955; *Volhand v Molenaar (Pty) Ltd v Ruskin NNO* 1959 (2) SA 751 (W) at 754G–H; *Guman v Latib* 1965 (4) SA 715 (A) at 722C; *Oertel v Brink* 1972 (3) SA 669 (W) at 674D.

<sup>181</sup> *Cession* at 237.

<sup>182</sup> Notice to the debtor of the existence of the pledge of claims does not necessarily mean that the debtor must afterwards pay the pledgee. The pledgee may still allow the debtor to pay the pledgor. Scott *Cession* at 238–239; Susan Scott “Pledge of Personal Rights and the Principle of Publicity” (1989) 52 *THRHR* at 461. See further GF Lubbe “Sessie in *Securitate* *Debiti* en die Komponente van die Skuldeisersbelang” (1989) 52 *THRHR* at 500–501. He argues that there should be a distinction in a cession *in securitate debiti* between the economic value of the claim that lies in the power to collect payment and lies with the cessionary, and the beneficial interest to dispose of the claim that remains with the cedent. This view has since not received much support. He also does not indicate whether such economic value will still vest with the cessionary/pledgee if the cedent/pledgor continues to collect payment. In a later article (1991 *Stell LR* at 148–149) Lubbe seems to favour a construction where the pledgee can collect in the absence of an agreement to the contrary. The pledgee must keep the proceeds until payment of the principal debt. See also the discussion below.

<sup>183</sup> See par 7.2.

<sup>184</sup> See par 2.8.

uncertain and concerned.<sup>185</sup> It should be added that while the investor in a securitisation scheme is usually sophisticated, the debtor of the transferred claims will often be the everyday person.

A further consideration in deciding whether notice ought to be a requirement for a pledge of claims is that if the pledge is only perfected after notice to the debtor, the security may be impeachable on the pledgor's subsequent insolvency shortly after notice was given.<sup>186</sup> The same considerations as those discussed with regard to a perfection of general notarial bonds will then apply.<sup>187</sup> However, this will rarely be a factor during securitisation, because the SPV is insulated as far as possible from insolvency.<sup>188</sup>

In a pledge of claims the entitlement to realise the claims is passed to the pledgee. However, the pledgee may not exercise this entitlement before default by the pledgor.<sup>189</sup> At the same time the pledgor cannot realise the claims, because he has transferred this entitlement to the pledgee. Since both the pledgor and the pledgee have interests in the claim, they should jointly institute action at this stage.<sup>190</sup>

Furthermore, the pledgor cannot accept payment by the debtor who has knowledge of the pledge before maturity of the pledge, nor can the pledgee, who only gains this entitlement when the pledgor cannot pay the debt.<sup>191</sup> Scott<sup>192</sup> suggests three possible solutions to this problem:

- 1 The parties may agree to notify the debtor to pay the pledgor and the pledgee jointly.
- 2 The debtor must pay the pledgor and the pledgee jointly and they should invest the money. A pledge is constituted in favour of the pledgee over the investment.

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<sup>185</sup> See further the comments by B Wunsh in Susan Scott *Sessie in Securitatem Debiti: Quo Vadis?* (1989) at 178.

<sup>186</sup> See ch 8.

<sup>187</sup> See par 5.4.2.4 above.

<sup>188</sup> See par 2.3.3.

<sup>189</sup> Also referred to as 'maturity' of the pledge. See *Land-en Landboubank van Suid-Afrika v Die Meester* 1991 (2) SA 761 (A) at 771D.

<sup>190</sup> Scott 1997 *THRHR* at 194–195.

<sup>191</sup> In *Volhand v Molenaar (Pty) Ltd v Ruskin NNO* 1959 (2) SA 751 (W) at 753G–H the Court described this result as absurd but declined to discuss it further, since it was not relevant to the exception stage of the proceedings.

<sup>192</sup> See Scott *Cession* at 242–243. See further Scott 1997 *THRHR* at 195.

- 3 The parties may agree that the debtor may pay the pledgee as representative of the pledgor. The pledgee will then keep the proceeds on behalf of the pledgor until maturity of the secured debt in a separate bank account. Alternatively the parties may agree that the pledgee will satisfy the debt owed to him from the proceeds.

The requirement of specificity in pledge is fulfilled in a pledge of claims by clearly describing the object of the pledge in the deed of cession.<sup>193</sup>

The majority of case law supports the pledge construction of security by means of claims.<sup>194</sup>

#### 5.4.3.2 Fiduciary security cession

It is also possible to create security by means of claims by way of a fiduciary security cession of claims.<sup>195</sup> In this construction the SPV will be the cedent and the trustee for debenture-holders the cessionary. The cessionary undertakes to cede the claims back to the cedent after the settlement of the secured claim. This agreement is a fiduciary agreement (*pactum fiduciae*).<sup>196</sup> Here the claims are transferred to the estate of the cessionary. This means that the claims cannot be used as security for more than one principal debt, even if the value of the claims is far more than the value of the principal debt. Furthermore, the cessionary receives more into his estate than the purpose of the cession, namely the provision of security, requires.

<sup>193</sup> Scott *Cession* at 238.

<sup>194</sup> See *National Bank of South Africa v Cohen's Trustee* 1911 AD 235; *Guman v Latib* 1965 (4) SA 715 (A); *Leyds v Noord-Westelike Koöperatiewe Landboumaatskappy Bpk* 1985 (2) SA 769 (A); *Marais v Ruskin* 1985 (4) SA 659 (A); *Bank of Lisbon and South Africa v The Master* 1987 (1) SA 276 (A); *Incedon (Welkom) (Pty) Ltd v QwaQwa Development Corporation Ltd* 1990 (4) SA 798 (A); *Land-en Landboubank van Suid-Afrika v Die Meester* 1991 (2) SA 761 (A); *Millman v Twiggs* 1995 (3) SA 674 (A); *First National Bank of South Africa v Lynn* 1996 (2) SA 339 (A). See also *Badenhorst et al Silberberg* at 396.

<sup>195</sup> *Lief v Dettmann* 1964 (2) SA 252 (A); *Trust Bank of Africa v Standard Bank of SA* 1968 (3) SA 166 (A), although it may be argued that the Court's pronouncement on cession in *securitatem debiti* in both these cases were *obiter dicta* (Strydom *Die Aksessoriteitsbeginsel* at 116–117 and 119). On fiduciary security cession in general, see Scott 1988 *THRHR* at 434; Susan Scott "Algehele Sekerheidsessies" (1989) 52 *THRHR* at 45; Scott 1997 *THRHR* at 197–201.

<sup>196</sup> It is uncertain whether our courts will allow a construction where the security cession is terminated by way of a suspensive condition on fulfilment by the cedent of his obligations under the secured debt. See Scott 1988 *THRHR* at 451–452. *Lief v Dettmann* 1964 (2) SA 252 (A) and *Trust Bank of Africa v Standard Bank of SA* 1968 (3) SA 166 (A) required an agreement for recession. While such a suspensive condition is possible in the German law, it is not customary.

It is important that parties to a fiduciary security cession pay careful attention to the terms of the *pactum fiduciae*.<sup>197</sup> Consequences that will follow automatically as a result of the accessory nature of a pledge of claims, such as that the security immediately comes to an end when the principal debt is satisfied, do not follow automatically in a fiduciary security cession and must be stipulated in the agreement.<sup>198</sup> The parties may further consider limiting the entitlements of the cessionary to transfer the claims and to provide expressly that any surplus amount collected from the claims must fall back to the cedent.<sup>199</sup> The contractual undertaking of recession is all that remains in the estate of the cedent, which has several undesirable consequences:

- Because the complete claim is transferred to the estate of the cessionary, it forms part of his estate.<sup>200</sup> This means that the ceded claims will be available to the cessionary's creditors inside and outside of his insolvency. In the event of the cessionary's insolvency, the personal rights in terms of the *pactum fiduciae* will have little value for the cedent.
- This type of transfer also means that no further security may be granted over these claims, regardless of whether their value exceeds that of the principal debt.
- Fiduciary security cession is not an accessory security. This implies that cession may occur before the underlying obligation comes into existence. When the secured obligation is extinguished due to payment or otherwise, the claims will not automatically fall back to the cedent.
- It is also possible for the cessionary to transfer the claims to third parties, although this will be in contravention of the *pactum fiduciae*. If such a transfer occurs, the cedent will have a claim for damages against the cessionary, but he will not be able to insist that the third party returns the claim to his estate.<sup>201</sup>

<sup>197</sup> For a detailed discussion of this aspect see Scott 1988 *THRHR* at 446–449. Aspects not discussed in detail here include adequate description of the parties to the agreement; stating whether the claims will also secure interest and collection costs; prohibition on settlement with the debtor; monitoring powers; the ratio between the value of the secured debt and the ceded claims.

<sup>198</sup> Scott *Cession* at 250. This agreement can be tacit, but it is better to put it in writing. See *Aussenkehr Farms (Pty) Ltd v Trio Transport CC* 2002 (4) SA 483 (SCA) at 492E–F.

<sup>199</sup> Although the Court has on occasion interpreted such provisions as indicating a simulated transaction. See *Skjelbreds Rederi A/S v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at 734B–E. See further Scott 1988 *THRHR* at 437–438.

<sup>200</sup> Scott *Cession* at 232.

<sup>201</sup> The security agreement does not bind third parties. See Scott 1988 *THRHR* at 437 and 442.

- South African courts have refused to allow a transfer of ownership as security.<sup>202</sup> By analogy, a fiduciary security cession could be seen as a simulated transaction. However, whereas a transfer of ownership as security of a corporeal security object usually lacks delivery of the object and therefore does not provide publicity of the transaction to third parties, there is no method of providing such publicity when claims are used as security. A lack of publicity can therefore not be used as a criterion to question fiduciary security cession.<sup>203</sup>

It is possible in a fiduciary security cession to stipulate that the cedent will continue to collect the book debts as the cessionary's representative and keep the proceeds.<sup>204</sup> Such a cession will occur without notice to the debtors until default by the cedent.<sup>205</sup>

Such an arrangement is usual where the intention is that the security will be continuing security; extinguished claims are continually being replaced with new ones.<sup>206</sup> The Supreme Court of Appeal has found that this arrangement effectively means that each claim is tacitly receded to the cedent.<sup>207</sup> This will continue until the cessionary asserts the right to collect the claims himself. Scott<sup>208</sup> argues that parties should institute action jointly under these circumstances, since the cedent is no longer creditor and the cessionary is only creditor for security purposes.

<sup>202</sup> *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 611A–F.

<sup>203</sup> I discuss simulated transactions in more detail in par 7.4.

<sup>204</sup> *Scott Cession* at 250; *Scott* 1997 *THRHR* at 197. See also *PG Bison Ltd v The Master* 2000 (1) SA 859 (SCA) at 864D–I. In this case the cedent, by agreement, continued to collect payment of the claims as agent of the cessionary. The Court never clearly indicated whether it considered the cession to be a pledge of claims or a full security cession. It describes the intention in the deed of cession as “a clear intention of an unconditional transfer of rights” (at 864D). Further on it states: “the appellants as cessionaries would in any event not be entitled to recover directly from the corporation's debtors until such time as the corporation is in default” (at 864I). This is the rule in a pledge of claims. The cessionary in a fiduciary security cession may claim payment from the debtors, unless otherwise agreed.

<sup>205</sup> Fiduciary security cession (*Sicherungsabtretung*) is the most popular form of security by means of claims in the German law. One of the main reasons for this popularity is that notice of the cession to the debtor is not required, while such notice is required for the creation of a valid pledge in German law. See *Scott* 1988 *THRHR* at 436.

<sup>206</sup> Also referred to as ‘revolving security cessions’. See *Scott* 1997 *THRHR* at 190; *Badenhorst et al Silberberg* at 400.

<sup>207</sup> *Aussenkehr Farms (Pty) Ltd v Trio Transport CC* 2002 (4) SA 483 (SCA) at 495C–F in the minority judgment by Marais JA.

<sup>208</sup> 1997 *THRHR* at 198.

Regardless of some concerns, there is support for the fiduciary security cession construction in case law and it is used in practice.<sup>209</sup>

## 5.5 FORM OF SECURITY GRANTED TO SECURITY SPV

From the discussion above it follows that the claims serve as security for the duties of the SPV towards its investors by way of a general notarial bond, a pledge of claims or a fiduciary security cession. I shall now consider the use of each of these forms of security during securitisation.<sup>210</sup>

### 5.5.1 General notarial bonds

Some of the concerns raised regarding a general notarial bond as a form of security<sup>211</sup> will not be as important in securitisation as when it is used to secure traditional debt, for the following reasons:

- The objects of the SPV are restricted. It is not allowed to trade or engage in activities unconnected with the securitisation scheme. It follows that there ought not to be any secured creditors other than the parties involved in the securitisation scheme. This greatly reduces the danger that the SPV will grant further security over the assets in priority to the general notarial bond. Furthermore, all parties involved in the SPV will have intimate knowledge of its structure. Such parties will probably not be able to escape the doctrine of notice if they try to take security, for instance a fiduciary security cession, in priority to a general notarial bond in favour of the debenture-holders.

<sup>209</sup> Whether security by means of claims ought to be classified as a pledge of claims or as a fiduciary security cession of rights in South African law has been debated for decades. In favour of a strict exclusion of the possibility of a pledge of personal claims are JC De Wet and JP Yeats *Die Suid-Afrikaanse Kontraktereg en Handelsreg* 4 ed (1978) at 365; JC De Wet en AH Van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* 5 ed (1992) at 416; Van der Merwe *Sakereg* at 675–679; PM Nienaber in Scott *Quo Vadis* at 169–170. In favour of the acceptance of the possibility of a pledge of personal claims are Scott *Cession* at 251 and Lubbe 1989 *THRHR* at 490. Both the latter authors believe that parties should be able to structure the security either in the form of a fiduciary security cession or as a pledge of claims. Badenhorst *et al Siberberg* at 399 *et seq* refrain from giving an opinion, but by implication support both options because a pledge of claims has been accepted by South African courts for more than a century. There is also a minority opinion that cession *in securitatem debiti* is a form of security *sui generis*, see JR Harker “Cession *in Securitatem Debiti*” (1981) 98 *SALJ* 56. In fact, the majority of case law prefers a pledge of claims rather than a fiduciary security cession when security is granted by means of claims. See n 194 above.

<sup>210</sup> Although I refer to ‘security SPV’ throughout, the security can in my opinion also be in favour of a trustee for debenture-holders. See par 2.8.2.2.

<sup>211</sup> See par 5.4.2.



- From the reasons given in the previous point, it further follows that more than one general notarial bond will not be registered over the assets. Consequently the problems surrounding perfection as discussed in paragraph 5.4.2.4 will not arise.
- The priority of other preferent creditors will be irrelevant, because the SPV is supposed to keep its taxable income at virtually null and it will have very few, if any, employees.<sup>212</sup>
- The security SPV can be given wide monitoring powers. This will assist in the timeous perfection of the general notarial bond.

The claims will remain in the estate of the SPV. The security SPV will not have to concern itself with notice to debtors until it becomes necessary to perfect the general notarial bond. Collection will be managed by the SPV, usually through the servicer. The general notarial bond is therefore an acceptable form of security in a securitisation scheme.

I argued in paragraph 2.8.2.2 that security during securitisation could also be granted in favour of a trustee for debenture-holders. There is one important point of uncertainty regarding registration in favour of a trustee that makes the use of a general notarial bond during securitisation doubtful.

Registration of mortgages and notarial bonds in favour of a trust has always been allowed by the Deeds Office by vesting the property in the name of the trustees for the time being, without specifying their names.<sup>213</sup> However, until 2003 there was no inclusion of a trust under the concept of a ‘person’ in the Deeds Registries Act.<sup>214</sup> The Act only allows for the conveyancing of title to ‘another person’.<sup>215</sup> A trust is not a legal person and therefore registrations could not be made in the name of a trust. This shortcoming was pointed out in *Joubert v Van Rensburg*.<sup>216</sup> The Court criticised the practice of the Registrar to allow registration in the names of ‘the trustees for the time

<sup>212</sup> See ss 98A and 99 of the Insolvency Act 24 of 1936. See also *Wood Title Finance* at 50 regarding the use of the floating charge in securitisation in the English law.

<sup>213</sup> HS Nel Jones *Conveyancing in South Africa* 4 ed (1991) at 364–365.

<sup>214</sup> 47 of 1937.

<sup>215</sup> Section 16.

<sup>216</sup> 2001 (1) SA 753 (W) at 768E–772B.

being’ as not providing sufficient certainty about the identity of the owner of the property.<sup>217</sup>

In response to these comments of the Court, the Deeds Registries Act was amended to include a trust under the concept of a ‘person’. However, instead of adopting the original draft of the amendment which read: “‘person’ includes a trust”,<sup>218</sup> the definition of ‘person’ now reads:<sup>219</sup>

In this Act unless inconsistent with the context – “person”, for the purpose of the registration of *immovable* trust property *only*, includes a trust (my emphasis).

It follows that while it is now possible to register land and mortgages over land in favour of trusts, it is still not possible to register notarial bonds in the name of a trust, because it relates to *movable property*.<sup>220</sup>

This has led the Chief Registrar to issue a circular in which he argues that there is no practical difference between vesting the title in the trustees for the time being or in the name of the trust.<sup>221</sup> On the computer system of the Deeds Office registration is always shown as in the name of the trust. Accordingly, the practice before the 2003 amendment is maintained in respect of notarial bonds in favour of trusts, by vesting the title in the name of the trustees for the time being.

However, despite this practice, the Court’s comments in *Joubert* are still valid, namely that a mere practice cannot override the requirements of the Deeds Registries Act or legal principles.<sup>222</sup> The fact remains that a trust is not a legal person and that the Act requires registration in the name of a person. The Act should therefore be amended to make provision for the registration of notarial bonds in the name of a trust. Until such an amendment is made, the use of the general notarial bond as security to investors during securitisation will not be on a sound footing and will lead to a lower rating of the securities.

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<sup>217</sup> At 770H–771I.

<sup>218</sup> AS West *The Practitioner’s Guide to Conveyancing and Notarial Practice* (2002) at 286-2.

<sup>219</sup> Section 102(1) of the Deeds Registries Act 47 of 1937, as amended by Act 9 of 2003.

<sup>220</sup> West *Conveyancing* at 286-2.

<sup>221</sup> Chief Registrar’s Circular 6 of 2004 *The Vesting with regard to Assets to be Registered in Favour of a Trust*, published in West *Conveyancing* at 295–297.

<sup>222</sup> At 769E.

### 5.5.2 Pledge of claims

The role of notice to debtors in a pledge of claims *before maturity* of the underlying debt remains unclear. In a pledge of claims the pledgor transfers the entitlement to realise the claims to the pledgee. However, the pledgee may not exercise this entitlement before default by the pledgor. At the same time the pledgor cannot realise the claims, because he has transferred this entitlement to the pledgee. Since both the pledgor and the pledgee have interests in the claim, they should jointly institute action at this stage. This is unworkable in a securitisation scheme. It would mean that the SPV and the security SPV would have to institute action against a defaulting debtor jointly. However, the debtor up until that time would have dealt only with the servicer and may not even be aware that the claim against him was subject to a securitisation scheme.

It is also unclear whether notice to the debtors is required to perfect the pledge as security.<sup>223</sup> Such a requirement will eliminate security by way of a pledge of claims as an option during securitisation. Notice might confuse the debtors,<sup>224</sup> it is costly, and administratively burdensome, especially when cession occurs continuously. Furthermore, the pledgor cannot accept payment by the debtor who has knowledge of the pledge, nor can the pledgee, who only gains this entitlement when the pledgor cannot pay the debt. This can be overcome by agreeing that the servicer will collect as representative of the pledgor and pledgee jointly.

However, this does not overcome the difficulty of what to do with the money after it has been collected. Strictly speaking, such money must be kept separately in pledge in favour of the pledgee.<sup>225</sup> However, the SPV relies on that income to service the debt securities issued. An inability of the SPV to use this income will render the scheme unworkable.

### 5.5.3 Fiduciary security cession

In a fiduciary security cession the cedent and the cessionary can agree that the cedent will continue to collect the claims as the cessionary's representative and keep the

<sup>223</sup> See also Scott *Cession* at 238–239. See also par 5.4.3.1.

<sup>224</sup> See also the comments by Wunsch in Scott *Quo Vadis* at 178, supported by Ussher at 179.

<sup>225</sup> See Scott *Cession* at 242–243. See further Scott 1997 *THRHR* at 195.

proceeds for himself.<sup>226</sup> Such an arrangement is the norm where the intention is that the security will be continuing security, in other words, old claims are continually replaced by new ones.<sup>227</sup> The parties will not notify the debtor of the cession under these circumstances, but will continue as before until maturity of the secured debt.

A minority judgment of the Supreme Court of Appeal found that this arrangement effectively meant that each debt is tacitly receded to the cedent.<sup>228</sup> This would continue until the cessionary asserts the right to collect the claims himself. Scott<sup>229</sup> argues that parties should institute action jointly under these circumstances, since the cedent is no longer creditor and the cessionary is only creditor for security purposes, which raises the same concerns as in the case of a pledge of claims.<sup>230</sup>

The claims will vest in the security SPV as cessionary and will not be in the estate of the SPV any longer. I discussed the potential difficulties with this situation in paragraph 5.4.3.2 above. However, since the SPV will have few other creditors, these concerns are less important during securitisation. The claims vest in the security SPV and there will be virtually no risk of the SPV granting further security over the claims or alienating it, due to the restrictions on the powers of the SPV.

## 5.6 CONCLUSION

In this chapter I showed that debt financing can be beneficial for shareholders, because of the principle of gearing.<sup>231</sup> However, gearing may also hold some risk for shareholders. The risks associated with debt financing are less in companies that have reached maturity in their specific industries.

Debt financing is a less attractive financing option for small, high-growth companies, because the restrictions and monitoring arrangements contained in debt financing agreements may conflict with their aims of research and development. When they do decide on debt financing, smaller companies will often prefer ‘insider

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<sup>226</sup> See par 5.4.3.2. This is a confidential security cession.

<sup>227</sup> Also referred to as ‘revolving security cessions’. See Scott 1997 *THRHR* at 190.

<sup>228</sup> *Aussenkehr Farms (Pty) Ltd v Trio Transport CC* 2002 (4) SA 483 (SCA) at 495C–F in the minority judgment by Marais JA.

<sup>229</sup> 1997 *THRHR* at 198.

<sup>230</sup> See above.

<sup>231</sup> See par 5.1.1.

debt'.<sup>232</sup> Even mature companies may prefer 'insider debt' in order to avoid negative signalling caused by the issuance of debt instruments on a securities exchange.

The Companies Act<sup>233</sup> provides for debt financing in the form of debentures. The term 'debentures' has never been uniformly defined, but I define it as a claim against a company, issued by a company to meet its capital requirements, where the holder is entitled to interest at specified intervals and repayment of the capital amount at a specified time.<sup>234</sup> I briefly discussed the relevance of the debenture certificate and specific provisions in the Companies Act relating to debentures. I explained the difference between debentures issued in series and debenture stock, which is of importance in the discussion on the trust for debenture-holders.<sup>235</sup>

I continued with an overview of the methods of providing security for debentures and other loans in South African law. I focused on the forms of security that may be used when the object of the security are claims, namely general notarial bonds and security by means of claims.

There are several reasons why the general notarial bond is a weak form of security:<sup>236</sup>

- An unperfected general notarial bond does not give its holder real security, but only a statutory preference on the insolvency of the debtor.
- Before perfection the debtor may alienate the encumbered property, may create real security over those assets in priority to the general notarial bondholder and the debtor's creditors may attach the encumbered property.
- The hypothecation of a shop, last discussed by Sacks, is, in my opinion, a form of special notarial bond. The decision of the Appellate Division in *Cooper NO v Die Meester*<sup>237</sup> held that the holder of such a bond does not enjoy a preference over the other creditors of the debtor. Security over the stock-in-trade cannot be created under the Security by Means of Movable Property Act,<sup>238</sup> because of its fluctuating nature which means that it cannot be described in the manner required

<sup>232</sup> See par 5.1.2.

<sup>233</sup> 61 of 1973.

<sup>234</sup> See par 5.2.1.

<sup>235</sup> See pars 2.8.2.2 and 2.8.2.2.3.

<sup>236</sup> See par 5.4.2.

<sup>237</sup> 1992 (3) SA 60 (A).

<sup>238</sup> 57 of 1993.

by the Act. Stock-in-trade will fall under a general notarial bond. I further concluded that even if third parties had actual knowledge of the general notarial bond over the stock-in-trade, they will be able to assume that it was the intention of the parties to the security agreement that the stock-in-trade may be alienated.<sup>239</sup>

- The perfection of general notarial bonds in current South African law gives rise to unsatisfactory results:<sup>240</sup>
  - Only the first general notarial bondholder that perfects his security will have a secured claim against the estate of the debtor.
  - The other general notarial bondholders will always only have a preference above the unsecured creditors of the debtor's insolvent estate, because only one person can take physical control of a security object.
  - This is the position regardless of the fact that the other general notarial bonds might have been registered before the one that was perfected.
  - Bondholders cannot effectively strengthen their position by means of contractual clauses to prevent later security over the assets, because third parties are not deemed to be aware of such clauses.
  - It makes no difference whether the other bondholders were only fractionally later than the successful bondholder in their attempts to perfect.
  - The provisional winding-up of the debtor will not cause a court to refuse to confirm an interim order for attachment in terms of a perfection clause.

I conclude that the legislature will have to reconsider the perfection of general notarial bonds in order to overcome the impossibility of more than one creditor taking control of the assets encumbered by a general notarial bond.<sup>241</sup> I suggest a system of receivership, whereby an application by any general notarial bondholder for the perfection of his bond will lead to the perfection of all notarial bonds. Priority will then be determined by the date of registration of the bonds and the receiver will act on behalf of all the bondholders in its dealings with the debtor.

I then considered security by means of claims in the form of a pledge of claims and a fiduciary security cession.

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<sup>239</sup> See par 5.4.2.2.

<sup>240</sup> See par 5.4.2.4.

<sup>241</sup> See par 5.4.2.4.1.

In a pledge of claims the main area of concern is the uncertainty that exists over the role of notice to the debtors as a requirement for perfection of the pledge.<sup>242</sup> I indicated that during securitisation notice of the pledge of claims to the debtors might cause them uncertainty and concern, because they would not have been informed about the initial cession of the claims to the SPV. It is also costly and administratively burdensome.

A fiduciary security cession does not require notice to debtors for validity, but it has unfavourable consequences of its own, especially on the insolvency of the cessionary or on the attachment of the claims by the cessionary's creditors.<sup>243</sup> In other legal systems these unfavourable consequences have been tempered so that security cession will more closely resemble pledge in the insolvency of the cessionary and when the cessionary's creditors want to attach the claims.<sup>244</sup> South African law will benefit from similar provisions,<sup>245</sup> which in my opinion can only be introduced through legislation.<sup>246</sup>

Additionally, legislation should also regulate a pledge of claims, but with the possibility of creating such a security without the need of notifying debtors. Such a system will function best if a register of a pledge of claims is introduced to replace the publicity function of notice to the debtors.<sup>247</sup>

After registration a pledge of claims will follow whether or not the debtor was informed of the pledge. The debtor must be able to satisfy the claim through payment to the pledgor until he receives notice that payment must be made to the pledgee. However, if the claim is under threat of attachment by other creditors of the pledgor, or in the event of the pledgor's insolvency, the pledgee will be a secured creditor even though no notice was given to the debtor.<sup>248</sup> Furthermore, if the pledgor grants further

<sup>242</sup> See par 5.4.3.1.

<sup>243</sup> See par 5.4.3.2.

<sup>244</sup> See Scott 1988 *THRHR* at 452–453; Scott 1997 *THRHR* at 434 *et seq.*

<sup>245</sup> See also Scott 1989 *THRHR* at 52–53; Scott 1997 *THRHR* at 444.

<sup>246</sup> With respect, South African courts have so far not done too well in developing this field of law on their own. Scott 1997 *THRHR* at 444 is also of the opinion that the courts interpret their role too conservatively to make these amendments on their own. She suggest that the only viable long-term solution to security by means of claims is extensive legislative intervention. In her opinion, such legislation ought to make provision for possessory and non-possessory pledge of claims, inclusion of the possibility to create a special notarial bond over claims and regulation of fiduciary security cessions (at 455).

<sup>247</sup> See Scott 1997 *THRHR* at 445 and 454–455.

<sup>248</sup> These consequences would have to be introduced through legislation. See Scott 1989 *THRHR* at 46.

security over the pledged claims, or cedes them to a third party, the pledgee will have a prior right to the proceeds of those claims by analogy to the position with regard to special notarial bonds.

The South African Law Commission investigated the position with regard to security by means of claims, but decided that no statutory intervention should take place.<sup>249</sup> This position should be reconsidered.<sup>250</sup> It is mostly businesses that make use of security by means of claims. Uncertainty about the consequences and application of security by means of claims is therefore detrimental to the ease with which businesses can obtain credit. Though this concern is of lesser importance for the securitisation process, it may influence the rating of the scheme.<sup>251</sup>

I considered the form of security by means of claims most suitable for a securitisation scheme.<sup>252</sup> I concluded that a general notarial bond, a pledge of claims or a fiduciary security cession may all be used in securitisation. Some of the concerns about the general notarial bond are of lesser concern in securitisation, due to the unique character of the scheme. However, the uncertain position of the registration of notarial bonds in the name of ‘the trustees for the time being’, as is currently the practice of the Registrar of Deeds, is unfortunate. I argued that the definition of ‘person’ in the Deeds Registries Act<sup>253</sup> ought to be amended to include trusts, also for registration of notarial bonds.<sup>254</sup>

When considering which form of security to use, it is important to avoid any necessity of having to give notice to the debtors about the scheme. Notice may cause uncertainty and concern and carries administrative and cost implications. The originator will probably also want to maintain a relationship with its debtors and would not want the debtors to make payments to a third party. Since it is still uncertain in South African law whether notice to the debtors is necessary to perfect a

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<sup>249</sup> South African Law Commission Project 46 *The Giving of Security by Means of Movable Property Report* (1991) at 129 (par 5.9.10), although it recommended in its Working Paper 23 (1987) at 118 (par 5.9.1) that a pledge of claims ought to be legislated.

<sup>250</sup> I would recommend that they look at the matter from the start. The original report did not consider all the problems associated with security by means of claims. See in this regard the comments by Scott 1997 *THRHR* at 447–452. Specifically, the original report did not consider the effect of a fiduciary security cession in the cessionary’s insolvency or attachment by his creditors.

<sup>251</sup> See par 2.6.

<sup>252</sup> Paragraph 5.5.

<sup>253</sup> 47 of 1937.

<sup>254</sup> See par 5.5.1.



pledge of claims, a fiduciary security cession of claims ought to receive better ratings from rating agencies.<sup>255</sup>

In conclusion, South African law does not provide a certain and robust method of creating security over claims. Securitisation provides an alternative method of liquidating claims and enhancing the working capital of a company. However, securitisation is not suitable for all companies.

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<sup>255</sup> See pars 5.5.2 and 5.5.3.



## CHAPTER 6 REGULATORY CONSIDERATIONS FOR TRADITIONAL SECURITISATIONS

### 6.1 INTRODUCTION

Securitisation in South Africa is not regulated in a single Act, but it is important to take cognisance of aspects from many statutes when structuring the scheme. In this chapter I consider various statutory provisions. The provisions mentioned in Chapter 2 where they are of specific importance to the general form and function of a securitisation scheme are not repeated here. I consider the implications of the Insolvency Act<sup>1</sup> on securitisation in Chapter 8, as well as those provisions of the Companies Act<sup>2</sup> that relate to the insolvency of the originator.

I do not think it is necessary to regulate securitisation extensively. In its investigation of the possible role that securitisation may play in advancing the micro-financing industry, the Task Group of the Policy Board for Financial Services and Regulation made the following statement, with which I agree:<sup>3</sup>

Securitisation represents *an advanced form of self-regulation*, in that the structures typically build in significant checks and balances, which are intended to eliminate any undue influence from any particular party to the transaction (my emphasis).

Especially the trustee for debenture-holders and the rating agency involved in the scheme have important monitoring functions,<sup>4</sup> which decreases the need for extensive statutory regulation.<sup>5</sup>

### 6.2 REGULATORY HISTORY OF SECURITISATION IN SOUTH AFRICA

A securitisation scheme must comply with the provisions of Securitisation Notice, 2008,<sup>6</sup> if an SPV intends to offer securities to the public. Securitisation Notice, 2008

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<sup>1</sup> 24 of 1936.

<sup>2</sup> 61 of 1973.

<sup>3</sup> *Access to Finance in South Africa: A Supply-Side Regulatory Review* (2001) at 154–155, available at [www.treasury.gov.za/documents/sme/p154\\_170.pdf](http://www.treasury.gov.za/documents/sme/p154_170.pdf) (accessed 6 September 2007).

<sup>4</sup> See par 2.6 and 2.8.2 for a discussion of the roles of these parties to the scheme.

<sup>5</sup> See also The Task Group of the Policy Board for Financial Services and Regulation *Access to Finance* at 157 and 163.

<sup>6</sup> GN 2, GG 30628 (1 January 2008), Notice on Banks Act 94 of 1990 – Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes).

exempts a securitisation scheme from falling under the definition of conducting the business of a bank, subject to compliance with its provisions.

Securitisation Notice, 2008 is the fourth of its kind and goes further than its predecessors in allowing securitisation in keeping with international practice, as well as complying with the recommendations of the revised Framework on International Convergence of Capital Measurement and Capital Standards published by the International Basel Committee.<sup>7</sup> I shall also discuss the three notices that preceded it, as well as Commercial Paper Notice, 1994.<sup>8</sup>

The common denominator in all these notices is that they exclude the activities of a securitisation scheme from falling under the definition of ‘the business of a bank’ as set out in section 1 of the Banks Act.<sup>9</sup>

### 6.2.1 Securitisation Notice, 1992

Securitisation Notice, 1992<sup>10</sup> was the first to exclude securitisation activities from falling under the definition of ‘the business of a bank’.<sup>11</sup> However, it precluded companies other than banks from engaging in securitisation.<sup>12</sup> This resulted from fears about disintermediation.

<sup>7</sup> See the Memorandum on the Objects of the Banks Amendment Bill, 2007 at 2, available at [www.treasury.gov.za](http://www.treasury.gov.za) (accessed 15 August 2007). The Framework on International Convergence of Capital Measurement and Capital Standards was published on 26 June 2004 and is available at [www.bis.org/publ/bcbs128b.htm](http://www.bis.org/publ/bcbs128b.htm) (accessed 15 August 2007). The reserve capital requirements of financial institutions do not form part of the subject matter of this discussion.

<sup>8</sup> GN 2172, GG 16167 (14 December 1994), Notice on Banks Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Commercial Paper).”

<sup>9</sup> 94 of 1990.

<sup>10</sup> GN R153, GG 13723 (3 January 1992), Notice on the Deposit-Taking Institutions Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘Business of a Deposit-taking Institution’ (Securitisation Schemes)”, hereinafter referred to as ‘Securitisation Notice, 1992’. On the provisions of this notice in general, see Itzikowitz & Malan 1996 *SA Merc LJ* at 175 *et seq.*

<sup>11</sup> Defined in s 1 of the Banks Act 94 of 1990. Of significance are subs (a) and (c)(iii) of the definition, which reads: “the business of a bank means (a) the acceptance of deposits *from the general public* ... as a regular feature of the business in question; (c) the utilization of money, or of the interest or other income earned on money, accepted by way of deposit as contemplated in (a) ... (iii) for the financing, wholly or to any material extent, by any person of any other business activity conducted by such person in his or her own name or through the medium of a trust or a nominee (my emphasis).” If the securities issued by an SPV will be privately placed with investors, these provisions do not apply, since it cannot be construed as constituting the business of a bank. See The Task Group of the Policy Board for Financial Services and Regulation *Access to Finance* at 164.

<sup>12</sup> A ‘securitisation scheme’ is defined in par 1 of the Schedule to the notice as “a scheme whereby a *deposit-taking institution* transfers to a special purpose institution, by virtue of a sale, such of its assets as consist of claims sounding in money (my emphasis).”

Disintermediation is a process by which banks do not perform their traditional lending function, but rather act as intermediaries between borrowers and lenders through brokerage and underwriting activities.<sup>13</sup> Banks are traditionally intermediaries in that they take deposits from the general public, which they then use to grant loans to the general public. During disintermediation borrowers and lenders approach each other directly and banks play a secondary role.

In terms of Securitisation Notice, 1992, income generated by the collection of the transferred claims could only be used by the SPV for redemption of the securities issued, the acquisition of further assets and the maintenance of the capital value of the assets held by the SPV.<sup>14</sup>

The notice further contained restrictions on the utilisation of excess cash flow from the transferred claims.<sup>15</sup> These funds had to be kept as reserves for the protection of the holders of the securities.<sup>16</sup> In the event of the SPV's winding-up or dissolution, the funds could be paid to the originator, the shareholders of the SPV or to the holders of the securities.

An originator, its subsidiaries and fellow subsidiaries were prohibited from holding any shares in the SPV and of controlling the SPV either directly or indirectly.<sup>17</sup> No director of an originator, or its subsidiaries, was allowed to serve on the board of the

<sup>13</sup> Itzikowitz & Malan 1996 *SA Merc LJ* at 176. Section 78(1)(g) of the Banks Act 94 of 1990 describes the following as an 'undesirable practice': "A bank shall not, for the purpose of effecting a money lending transaction directly between a lender and a borrower, perform any act in the capacity of an agent except where the funds to be lent in terms of the money lending transaction are entrusted by the lender to the bank subject to a written contract of agency in which, in addition to any other terms thereof, at least the following matters shall be recorded: (i) Confirmation by the lender that the bank acts as the agent of the lender; (ii) that the lender assumes, except so far as the lender may in law have a right of recovery against the bank, all risks connected with the placing by the bank of funds entrusted to it by the lender, as well as the responsibility to ensure that the bank executes the lender's instructions as recorded in the written contract of agency; and (iii) that no express or implied guarantee regarding the payment of any amount of money owing by one person to another in pursuance of the relevant money lending transaction is furnished by the bank." For an interesting perspective on the history of intermediation see Charles P Kindleberger *The World Economy and National Finance in Historical Perspective* (1995) at 131 *et seq*, entitled "Intermediation, Disintermediation, and Direct Trading".

<sup>14</sup> Schedule, par 3(c).

<sup>15</sup> Schedule, par 3(g)(i) and (ii).

<sup>16</sup> See par 2.5 for a discussion of a reserve account as a credit enhancement.

<sup>17</sup> Schedule, par 3(d)(i) and (ii).

SPV.<sup>18</sup> The name of the SPV could not contain any reference to the name of an originator or its subsidiaries, nor could the name imply any association with them.<sup>19</sup>

The originator was allowed to act as servicer.<sup>20</sup> However, further participation of the originator was limited. The notice prohibited an originator, which was always a bank, from providing liquidity support to the securitisation scheme.<sup>21</sup> The originator could not underwrite or guarantee the issue of securities by the SPV.<sup>22</sup> Third party credit enhancement<sup>23</sup> at market prices and subordinated long term loans to the SPV by the originator were allowed.<sup>24</sup>

The notice aimed at ensuring that the sale of the assets to the SPV would divest the originator of all risks associated with the assets.<sup>25</sup> Any recourse by the SPV against the originator for loss sustained from the transferred claim was excluded.<sup>26</sup> However, the originator was allowed to replace one claim with another, as long as this was not due to the non-performance of the original claim.<sup>27</sup>

If any of these requirements were not met by the originator bank, the bank would have to reflect the transferred assets on its balance sheet,<sup>28</sup> which would lead to higher capital adequacy requirements.<sup>29</sup> The SPV would further not be exempted in terms of the notice, which meant that it would be regulated as a bank.

## 6.2.2 Commercial Paper Notice, 1994

In terms of Commercial Paper Notice, 1994<sup>30</sup> the acceptance of money from the general public against the issue of commercial paper in accordance with the

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<sup>18</sup> Schedule, par 3(e).

<sup>19</sup> Schedule, par 3(f).

<sup>20</sup> See par 2.7.

<sup>21</sup> Schedule, par 3(h)(i) and (ii). See par 2.5 for a discussion of liquidity support.

<sup>22</sup> Schedule, par 3(h)(iv).

<sup>23</sup> See par 2.5.

<sup>24</sup> Itzikowitz & Malan 1996 *SA Merc LJ* at 179.

<sup>25</sup> Schedule, par 4(a).

<sup>26</sup> Schedule, par 4(c).

<sup>27</sup> *Idem*.

<sup>28</sup> Schedule, par 5.

<sup>29</sup> See Itzikowitz & Malan 1996 *SA Merc LJ* at 182 and 186–188. See generally Basel Committee on Banking Supervision *Asset Securitisation: Supporting Document to the New Basel Capital Accord* (2001).

<sup>30</sup> GN 2172, GG 16167 (14 December 1994).

provisions of the notice will not be an activity that falls under the definition of ‘the business of a bank’.<sup>31</sup> Issues of commercial paper by securitisation schemes have been regulated in Securitisation Notice since 2001, but the provisions of Commercial Paper Notice still applies to other issues of commercial paper.

In terms of the Notice ‘commercial paper’ means:<sup>32</sup>

- (a) Any written acknowledgement of debt irrespective of whether the maturity thereof is fixed or based on a notice period, and irrespective of whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; and
- (b) Debentures or any interest-bearing written acknowledgment of debt issued for a fixed term in accordance with the provisions of the Companies Act, 1973 (Act No. 61 of 1973),

but does not include bankers’ acceptances

The Notice prescribes the following:<sup>33</sup>

- Commercial paper may only be issued or transferred in denominations equal to or greater than R1 million.<sup>34</sup> This is the first of two requirements that, before Securitisation Notice, 2004, effectively restricted securitisation in South Africa to originators with large enterprises. Smaller issues of commercial paper could not be made in compliance with the Notice. It further means that if the commercial paper is not listed, mostly institutional or professional investors will be able to invest.
- Commercial paper may only be issued by a listed company, or by a company that for at least the past 18 months had net assets exceeding R100 million, as certified by its auditors and reflected in its financial statements, or by any other juristic person so authorised in writing by the Registrar of Banks.<sup>35</sup> When they were still applicable to securitisation schemes, these requirements further restricted securitisation to originators with large enterprises.
  - These first two restrictions do not apply if the securities are listed on a recognised financial exchange, or are endorsed by a bank, or are issued for longer than five years, or are issued or backed by Central Government.<sup>36</sup>

<sup>31</sup> Schedule, par 2.

<sup>32</sup> Schedule, par 1.

<sup>33</sup> In the context of securitisation, the issuer will be the SPV. This should be read into the requirements.

<sup>34</sup> Schedule, par 3(1)(a).

<sup>35</sup> Schedule, par 3(1)(b).

<sup>36</sup> Schedule, par 3(1)(b)(iii)(A)–(E).

- The ultimate borrower of the money obtained through the issue of commercial paper may only be the issuer, or a wholly owned subsidiary of the issuer, or the holding company of the issuer, or a company whose board of directors is controlled by and customarily acts in accordance with the directions or instructions of the issuer.<sup>37</sup> Since the originator could be construed as the ultimate borrower, and would not ordinarily be the holding company of the SPV, this provision was a possible obstacle to securitisation.
- The funds raised through the issue of commercial paper may only be used for the ultimate borrower's operating capital. It may not be applied, directly or indirectly, for the granting of money loans or credit, excluding credit for a sale of goods, to the general public.<sup>38</sup>
- The notice sets out the minimum disclosure requirements to be included in a placing document or prospectus relating to the issue of the commercial paper.<sup>39</sup> These requirements aim to aid a potential investor in assessing the risk of investing in the issued commercial paper. The issuer must declare that it is a going concern and can in all circumstances be reasonably expected to meet its commitments.<sup>40</sup> Any material adverse change in the issuer's financial position since the date of its last audited financial statements must be declared.<sup>41</sup> The issuer's auditor must certify that the issue complies in all respects with the provisions of the notice.

### 6.2.3 Securitisation Notice, 2001

By the late 1990s the South African Reserve Bank realised that it had to expand its regulations on securitisation in order to bring them in line with the more or less standardised approach followed by the Group of Ten.<sup>42</sup> Securitisation Notice, 2001 followed.<sup>43</sup>

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<sup>37</sup> Schedule, par 3(2).

<sup>38</sup> Schedule, par 3(4).

<sup>39</sup> Schedule, par 3(5).

<sup>40</sup> Thereby reflecting the adequacy of its liquidity and solvency. If a securitisation is properly structured, the SPV should have no liquidity or solvency inadequacies.

<sup>41</sup> The issuer's last audited financial statements must accompany the issue.

<sup>42</sup> Also referred to as the 'G10' these are 11 industrialised countries that co-operate on monetary, financial and economic matters. The participating countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. See



The first important difference between Securitisation Notice, 2001 and its predecessor is that it allowed non-banking institutions to engage in securitisation, while being exempt from complying with the Banks Act.<sup>44</sup> However, more stringent rules applied to banks that engaged in securitisation activities.<sup>45</sup>

An institution other than one within a banking group could engage in a securitisation scheme and be exempted from falling under the meaning of ‘the business of a bank’, provided that the conditions of the notice were met and that the SPV only engaged in activities related to the securitisation scheme.<sup>46</sup> Most of these provisions were taken over in Securitisation Notice, 2004 as far as they related to traditional securitisation.

The notice required that the transfer of the assets to the SPV would divest the originator of all rights and obligations originating from the transactions that gave rise to the assets (claims).<sup>47</sup> However, the originator was allowed to act in a secondary role.<sup>48</sup> The notice contained no restrictions on the secondary roles that an originator may engage in when the originator does not fall within a banking group.

The prohibition of recourse against the originator for non-performing transferred assets as set out in Securitisation Notice, 1992, was retained,<sup>49</sup> as were the provisions that allowed warranties with regard to matters that do not relate to the future

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the Bank for International Settlements’ discussion at [www.bis.org/publ/g10.htm](http://www.bis.org/publ/g10.htm) (accessed 17 September 2007).

<sup>43</sup> GN 1375, GG 22948 (13 December 2001), Notice on Banks Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes)”, hereinafter referred to as ‘Securitisation Notice, 2001’. On Securitisation Notice, 2001 with regard to the position relating to banks see Jonathan GF Walsh & Edward Sunderland “New South African Securitisation Guidelines Herald Active Securitisation Market for South Africa” (2002) 17 *JIBL* 133 *et seq.*

<sup>44</sup> 94 of 1990. In its definition of ‘originator’ in the Schedule, par 1, Securitisation Notice, 2001 does not restrict its meaning to deposit-taking institutions as was the case with Securitisation Notice, 1992. See n 12 above. Likewise, the definition of ‘securitisation scheme’ (Schedule, par 1) focuses on the process after transfer of the assets and simply refers to an ‘originator’.

<sup>45</sup> Especially when banks engage in secondary roles. See the Schedule, pars 4–10.

<sup>46</sup> The conditions of Securitisation Notice, 2001 relevant to institutions not falling within a banking-group were set out in the Schedule, pars 3 and 11–13.

<sup>47</sup> Schedule, par 3(a).

<sup>48</sup> *Idem.* ‘Secondary role’ is defined in par 1 as “a credit-enhancement facility, a provider of a liquidity facility, an underwriter, a purchaser of senior commercial paper, a servicing agent or a counter party to a transaction included in the trading book of a bank.” See also n 56 below.

<sup>49</sup> Schedule, par 3(b). See par 6.2.1.

creditworthiness of the debtor or about matters that fall outside the control of the originator.<sup>50</sup>

There were no express restrictions on the use of the proceeds collected from the transferred assets after their transfer as was the case with Securitisation Notice, 1992.<sup>51</sup> Nor were there express restrictions on the use of excess money collected from the transferred assets. However, such restrictions must be contained in the constitutive documents of the SPV in order for it to obtain a favourable credit rating.<sup>52</sup>

Contrary to the 1992 notice, Securitisation Notice, 2001 allowed the originator to hold up to 50 percent of the nominal value of the share capital issued by the SPV.<sup>53</sup> The originator was allowed to hold even more shares, as long as the voting rights attached to the shares were restricted so that the originator could not decisively influence the outcome of the voting at the general meeting of the SPV.<sup>54</sup> The latter provision was ambiguous, since a shareholding of up to 50 per cent, which carries full voting rights, will in any case often influence the decisions at a general meeting decisively.

The board of directors of the SPV had to be independent of the originator, but if there were more than three members on the board, the originator was allowed to appoint one director.<sup>55</sup>

The notice extended the ability of banks, also when a bank was an originator, to act in a credit enhancement capacity during securitisation. However, this was subject to some qualifications, which mostly aimed to keep the credit enhancement at arm's length.<sup>56</sup>

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<sup>50</sup> Schedule, par 3(c)(i) and (ii).

<sup>51</sup> See par 6.2.1 above.

<sup>52</sup> See par 2.3.3.

<sup>53</sup> Schedule, par 3(j)(i)

<sup>54</sup> Schedule, par 3(j)(i)(aa).

<sup>55</sup> Schedule, par 3(k)(i).

<sup>56</sup> Schedule, par 4. The qualifications were as follows: there could be no recourse to the bank apart from the fixed contractual obligations; the SPV must have retained the right to change credit enhancers; the credit enhancement must be clearly and separately documented from the other functions of the participating bank; the continued role of the banks must be disclosed in the prospectus or placing documents; if the bank is also the originator, it can only enter into credit enhancement agreements at the beginning of the scheme.

Securitisation Notice, 2001 contained conditions for the issue of commercial paper by an SPV during a securitisation scheme,<sup>57</sup> which replaced the conditions of Commercial Paper Notice, 1994. These conditions have remained unchanged in Securitisation Notice, 2004 as well as in Securitisation Notice, 2008. These conditions are as follows:

- Commercial paper issued during securitisation can only be issued or transferred in minimum denominations equal to or greater than an initial principal value of R1 million.<sup>58</sup>
  - This restriction does not apply if the commercial paper is listed on a recognised financial exchange, is endorsed by a bank, is issued for a period longer than five years, or is backed by an explicit national Government guarantee.
- Commercial paper issued during securitisation may only be issued by a juristic person authorised by the Registrar of Banks in writing and subject to the conditions of the notice and any other conditions that the Registrar may determine.<sup>59</sup>
- Specific information must be included in the placing document or disclosure document accompanying the issue of the commercial paper.<sup>60</sup> As with other documents of this sort,<sup>61</sup> the aim is to provide investors with enough information so that they may ascertain the nature of their financial and commercial risk in the investment. Of specific importance is the requirement that the transferred assets must be described. The auditor of the SPV must confirm that the issue of the commercial paper pursuant to a securitisation complies in all respects with the provisions of the notice.

The provisions listed above differed from Commercial Paper Notice, 1994 in two respects. First, they enabled smaller originators to enter a securitisation scheme through the issue of commercial paper. Second, they removed the restrictions on the utilisation of the funds obtained from the issue of commercial paper by the ultimate

<sup>57</sup> Schedule, par 11.

<sup>58</sup> Schedule, par 11(a)(i).

<sup>59</sup> Schedule, par 11(a)(ii).

<sup>60</sup> Schedule, par 11(b). The Registrar may prescribe additional disclosure requirements in respect of securitisation schemes. See the Schedule, par 12(b).

<sup>61</sup> See ss 145, 146, 148 and Schedule 3 of the Companies Act 61 of 1973.

borrower during a securitisation scheme. The ultimate borrower in securitisation could be seen as the originator. This would contravene some of the provisions of Commercial Paper Notice, 1994.<sup>62</sup>

Chapter VIII of the Banks Act 94 of 1990 would apply to SPVs that did not comply with the provisions of the notice.<sup>63</sup>

#### 6.2.4 Securitisation Notice, 2004

Securitisation Notice, 2004<sup>64</sup> did not differ much from its predecessor regarding traditional securitisation schemes. It drew a specific distinction between when an institution within a banking group acts as an originator and when an institution other than within a banking group acts in that role. The main contribution of Securitisation Notice, 2004 was to regulate synthetic securitisation schemes.<sup>65</sup>

The notice provided that the acceptance by an SPV of money from the general public against the issue of commercial paper<sup>66</sup> in respect of a traditional securitisation scheme was not an activity that falls within the meaning of ‘the business of a bank’,<sup>67</sup> as long as the scheme complied with the relevant provisions of the notice.<sup>68</sup> The exemption only applied if the SPV engaged in no other transactions than those relating to the securitisation.<sup>69</sup>

The transfer of the assets to the SPV had to divest the originator and all its associated companies<sup>70</sup> of all rights and obligations originating from the transactions that gave rise to the transferred claims.<sup>71</sup> All risks associated with the claims also had

<sup>62</sup> See further The Task Group of the Policy Board for Financial Services and Regulation *Access to Finance* at 165.

<sup>63</sup> Schedule, par 13(b). See par 6.3 below.

<sup>64</sup> GN R681, GG 26415 (4 June 2004) Notice on Banks Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes)”, hereinafter referred to as ‘Securitisation Notice, 2004’.

<sup>65</sup> See ch 1 for a definition of synthetic securitisation. Synthetic securitisation falls outside the scope of this thesis.

<sup>66</sup> For purposes of Securitisation Notice, 2004, the definition of ‘commercial paper’ in Commercial Paper Notice, 1994 is extended to include the issue of preference shares. See Schedule, par 1. This is retained in Securitisation Notice, 2008, Schedule, par 1. See further the discussion below.

<sup>67</sup> Schedule, par 2(1).

<sup>68</sup> For institutions that fall outside banking groups, the relevant provisions of the Schedule were pars 4 and 13–16. Par 4(1) was descriptive and had no binding effect.

<sup>69</sup> Schedule, par 2(1)(c).

<sup>70</sup> ‘Associated company’ means a subsidiary or fellow subsidiary of the institution. See Schedule, par 1.

<sup>71</sup> Schedule, par 4(2)(a). See also Securitisation Notice, 2008, Schedule, par 4(2)(a).

to be transferred. The SPV must have had no right of recourse against the originator in respect of costs, expenses or losses incurred in connection with any of the transferred claims.<sup>72</sup> However, the originator was allowed to make warranties with regard to the transferred claims, as long as those warranties did not relate to the future creditworthiness of the originator, or to matters that fell outside the control of the originator.<sup>73</sup>

There were no restrictions on institutions that were not banks to act in secondary roles.<sup>74</sup> ‘Secondary roles’ was defined as credit enhancement facilities,<sup>75</sup> liquidity facilities,<sup>76</sup> underwriting,<sup>77</sup> purchasing senior commercial paper,<sup>78</sup> and acting as servicer<sup>79</sup> or as counterparty to a transaction included in the trading book of a bank. If the originator entered into a swap agreement with the SPV in which the originator would bear losses in respect of the transferred assets, the provisions relating to credit enhancement in paragraph 6 were applicable.<sup>80</sup> However, these credit enhancement provisions were only applicable to banks. Furthermore, paragraph 2, which set out the paragraphs of the Schedule that non-banking institutions had to comply with in terms of the notice, made no mention of compliance with paragraph 6. In my opinion the provision on swaps was not intended to cover non-banking institutions and it ought to be amended accordingly.<sup>81</sup>

<sup>72</sup> Schedule, par 4(2)(b). See also Securitisation Notice, 2008, Schedule, par 4(2)(c). See further the discussion in par 7.4.2.

<sup>73</sup> Schedule, par 2(2)(c)(i) and (ii). See also Securitisation Notice, 2008, Schedule, pars 4(2)(d)(i) and (ii).

<sup>74</sup> This position remains unchanged in Securitisation Notice, 2008.

<sup>75</sup> See par 2.5.

<sup>76</sup> *Idem*.

<sup>77</sup> ‘Underwriting’ in terms of the notice means exposure that includes all underwriting commitments, whether in writing or verbally, including all note-issue facilities and revolving underwriting facilities in respect of which contingent risks arise from the bank’s role as underwriter of such issues, guaranteeing to provide funds when other parties refused to do so. See Schedule, par 1. The definition was probably meant to include non-banks, even though it only refers to banks.

<sup>78</sup> ‘Senior commercial paper’ means commercial paper issued in terms of a traditional securitisation scheme, the purchase of which commercial paper does not constitute providing a first-loss or second-loss credit enhancement facility. See Schedule, par 1. In other words, the originator is allowed to purchase commercial paper issued by the SPV, as long as it is not subordinated. See par 2.5.

<sup>79</sup> See par 2.7.

<sup>80</sup> Schedule, par 6.

<sup>81</sup> These provisions were retained unchanged in Securitisation Notice, 2008, Schedule, pars 4(2)(n) and 6.

If the originator, or one of its associated companies, acted as a servicer, it had to be under no obligation to remit funds to the SPV before it had received payment from the debtor of the transferred claim.<sup>82</sup>

In the choice of the claims to be transferred to the SPV, the parties must have ensured that the transfer would not result in a breach of the terms of the transaction that gave rise to the claim.<sup>83</sup> The type of restriction that comes to mind is an agreement prohibiting the transfer of a claim between the originator and the debtor of the claim.<sup>84</sup> Even if the restriction is such that the claim may be transferred with the consent of the debtor, it can severely hamper the securitisation process, especially if the restriction was a standard term of the loan agreements that gave rise to the claims that the originator wants to transfer. It will further mean that the originator will have to give notice of the securitisation of the claims, which may lead to uncertainty and concern among debtors. Large companies should therefore consider not including such restrictions in their standardised contracts, even if they are not planning a securitisation in the immediate future.<sup>85</sup>

In terms of the agreement between the originator and the SPV, any amendment of the terms of the agreements that gave rise to the transferred claims would only affect the SPV and not the originator.<sup>86</sup>

The ambiguous provisions regarding the shareholding of an originator in an SPV in Securitisation Notice, 2001 were amended. Securitisation Notice, 2004 only allowed

<sup>82</sup> Schedule, par 4(2)(d). See also Securitisation Notice, 2008, Schedule, par 4(2)(f).

<sup>83</sup> Schedule, par 4(2)(e). See also Securitisation Notice, 2008, Schedule, par 4(2)(g).

<sup>84</sup> Also referred to as a *pactum de non cedendo*. See Scott *Cession* at 205 *et seq*; PM Nienaber “Cession” in WA Joubert *et al The Law of South Africa Vol 2 Part 2* 2 ed (2003) at 28. A *pactum de non cedendo* is valid and binding if it can be shown to serve a useful purpose to the debtor. See *Paiges v Van Ryn Gold Mines Estates Ltd* 1920 AD 600 at 615. The agreement will also be valid if it was part and parcel of the agreement that created the right. See *Trust Bank of Africa v Standard Bank of SA* 1968 (3) SA 166 (A) at 189F. For criticism of the current approach, see Scott *Cession* at 213–214. She distinguishes between the creation of a *pactum de non cedendo* for existing rights as opposed to the position where the restriction is part of the agreement that gave rise to the right from the start. In the former case, she argues that a debtor must show that he has an interest in the restriction. Otherwise the restriction will be contrary to the principle in Roman-Dutch law of property that *res in commercio* should not be withdrawn from commercial dealings without good reason. A cession despite a valid *pactum de non cedendo* in such circumstances will only lead to a claim for damages against the cedent and will not affect the validity of the cession against the cessionary. If the *pactum de non cedendo* formed part of the agreement creating the right, the principle of freedom of contract will lead to the validity of the restriction. Any attempted cession will be void. Nothing will be transferred to the cessionary, since the right was created as an intransferable right. I agree with Scott’s view.

<sup>85</sup> I shall consider the cession of the claims to the SPV in detail in ch 7.

<sup>86</sup> Schedule, par 4(2)(g). See also Securitisation Notice, 2008, Schedule, par 4(2)(j).

an originator directly or indirectly to hold up to 20 per cent of the shareholding in the SPV, as opposed to the previous 50 per cent.<sup>87</sup> In addition, the originator must not have had the right to determine the outcome of the voting at a general meeting of the SPV.<sup>88</sup> The provisions for representation of the originator on the board of directors of the SPV remained unchanged in all four Securitisation Notices.<sup>89</sup>

The provisions for special treatment of commercial paper issued by an SPV during a securitisation scheme were retained in Securitisation Notice, 2004.<sup>90</sup> Accordingly, Commercial Paper Notice, 1994 did not apply to an issue of commercial paper by an SPV during a securitisation scheme, provided that the issue complied with the provisions of the notice.

The disclosure requirements were further extended and included a statement to investors that their investment did not represent deposits in a bank, that the instruments were subject to investment risk and that the originator and its associated companies did not guarantee the capital value or the performance of the instruments issued by the SPV.<sup>91</sup> Credit enhancement facilities and liquidity facilities had to be disclosed.<sup>92</sup> There had to be an express statement that the board of directors of the SPV were independent of the originator.<sup>93</sup>

Chapter VIII of the Banks Act<sup>94</sup> applied to an SPV that implemented a securitisation scheme which did not comply with the notice.<sup>95</sup>

### 6.2.5 Securitisation Notice, 2008

On 1 January 2008 Securitisation Notice, 2004 was repealed in its entirety and replaced by Securitisation Notice, 2008.<sup>96</sup> However, the new Securitisation Notice

<sup>87</sup> Schedule, par 4(1)(i)(aa). See also Securitisation Notice, 2008, Schedule, par 4(2)(p)(i)(A).

<sup>88</sup> Schedule, par 4(1)(i)(bb). See also Securitisation Notice, 2008, Schedule, par 4(2)(p)(i)(B).

<sup>89</sup> It is provided for in Securitisation Notice, 2004 in the Schedule, par 4(m). See also Securitisation Notice, 2008, Schedule, par 4(2)(q).

<sup>90</sup> See pars 6.2.2 and 6.2.3.

<sup>91</sup> Schedule, par 15(1)(a). See also Securitisation Notice, 2008, Schedule, par 16(2)(a)(x).

<sup>92</sup> Schedule, par 15(2)(viii) and (ix). See also Securitisation Notice, 2008, Schedule, par 16(2)(a)(viii) and (ix).

<sup>93</sup> Schedule, par 15(2)(xi). See also Securitisation Notice, 2008, Schedule, par 16(2)(a)(xi).

<sup>94</sup> 94 of 1990.

<sup>95</sup> Schedule, par 16(1)(c).

<sup>96</sup> GN 2, GG 30628 (1 January 2008) Notice on Banks Act 94 of 1990 – Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes).

does not materially alter the previous position as set out in Securitisation Notice, 2004. For the most part it adds certain provisions on matters that were not previously addressed. Securitisation Notice, 2008 accompanies the Banks Amendment Act 20 of 2007, which also commenced on 1 January 2008.<sup>97</sup>

In order to avoid unnecessary repetition, I indicated the relevant paragraph numbers of Securitisation Notice, 2008 in my discussion of Securitisation Notice, 2004, where the provisions of the latter have been retained unchanged. In this section I shall only pay attention to the additions in the new notice.

As with its predecessors, the notice provides that the acceptance by an SPV of money from the general public against the issue of commercial paper in respect of a traditional securitisation scheme is not an activity that falls within the meaning of ‘the business of a bank’,<sup>98</sup> as long as the scheme complies with the relevant provisions of the Notice.<sup>99</sup> This exemption will only apply if the SPV engages in no other transactions than those relating to the securitisation.<sup>100</sup>

As was the case in the previous two notices, the provisions of Securitisation Notice, 2008 that deal with asset-backed issues of commercial paper supersedes the provisions of Commercial Paper Notice, 1994. However, the provisions set out in Securitisation Notice, 2001 remain unchanged.<sup>101</sup>

As in the previous notice, it is a requirement that the transfer of the assets to the SPV must divest the originator of all rights and obligations connected with the underlying claims and that all risks in connection with the assets are transferred to the SPV. However, Securitisation Notice, 2008 elaborates on this by prohibiting the originator and its associated companies from having the right to impose restrictive conditions on the ability of investors in the SPV to pledge or exchange the securities issued by the SPV.<sup>102</sup> It is unclear why the need for this paragraph was felt, since it is generally not the practice for such conditions to be imposed.

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<sup>97</sup> See par 6.3.1 below.

<sup>98</sup> Schedule, par 2(1).

<sup>99</sup> For institutions that fall outside banking groups, the relevant provisions of the Schedule are pars 4 and 14–16. Par 4(1) is descriptive and has no binding effect.

<sup>100</sup> Schedule, par 2(1)(c).

<sup>101</sup> See par 6.2.3.

<sup>102</sup> Schedule, par 4(2)(a)(iii).



For the first time Securitisation Notice carries a paragraph devoted solely to the aspect of continued control of the assets by the originator and its impact on insolvency-remoteness.<sup>103</sup> The transferor may not maintain any effective or indirect control over the assets after transfer to the SPV. The assets and the benefits flowing from those assets must be transferred to the SPV in such a manner that it is beyond the reach of the transferor (originator) even in the event of its insolvency. The transferor is deemed to have maintained effective control over the transferred assets when the transferor is able to repurchase the assets from the SPV in order to realise their benefits or if it is obliged to retain the risk relating to the transferred assets.<sup>104</sup> The continued servicing of the assets by the transferor is expressly excluded as a form of indirect control of the assets.<sup>105</sup>

Securitisation Notice, 2008 expressly states that the commercial paper issued by the SPV shall not constitute a direct or an indirect obligation on the originator and that the investors in the securities shall only have a claim against the SPV, which claim is secured by the assets transferred to the SPV.<sup>106</sup>

There is a new provision in the notice that prohibits three kinds of clauses in securitisation agreements. First, the originator is prohibited from undertaking systematically to alter the quality of the underlying exposures so that the pool of asset's weighted average credit quality is improved.<sup>107</sup> Second, when the originator acts as a credit enhancer of the scheme, it is not allowed after the inception of the scheme to increase its exposure in terms of the credit enhancement.<sup>108</sup> Lastly, there may not be a clause in the agreements providing that the yield payable to the parties involved in the scheme, such as the investors and third party credit enhancers, will be increased if the credit quality of the assets in the pool deteriorates.<sup>109</sup>

The new provisions of Securitisation Notice, 2008 seem to indicate that there is an increased awareness on the part of regulators that continued control by the originator of the assets after transfer to the SPV may pose problems to the integrity of the

<sup>103</sup> Schedule, par 4(2)(b).

<sup>104</sup> Schedule, par 4(2)(b)(ii)(A) and (B).

<sup>105</sup> Schedule, par 4(2)(b)(iii).

<sup>106</sup> Schedule, par 4(2)(e).

<sup>107</sup> Schedule, par 4(2)(o)(i).

<sup>108</sup> Schedule, par 4(2)(o)(ii).

<sup>109</sup> Schedule, par 4(2)(o)(iii).

scheme. Most of the provisions aim to ensure that the originator's role after the transfer is limited and well described, so that the originator cannot increase its involvement if the transferred assets do not perform as expected.

For the first time the Notice makes provision for the validity of a 'clean-up call'. A 'clean-up call' is defined in relation to a traditional securitisation scheme as an option to call or repay the commercial paper issued in terms of the securitisation scheme before all the underlying assets have been repaid. Alternatively, it can mean an option for the repurchase of the remaining assets once the pool balance or outstanding securities have fallen below a specified level.<sup>110</sup> Paragraph 11 deals with the circumstances in which an originator need not maintain capital in respect of a clean-up call contained in a securitisation agreement. Paragraph 11 is phrased widely, not mentioning banks or institutions within a banking group expressly. However, from the content of the paragraph, coupled with the fact that paragraph 11 is not mentioned in paragraph 2(1)(b) as one with which an institution outside a banking group must comply, I submit that these provisions are only applicable to banks. In essence, they provide that the clean-up call must at all times remain in the discretion of the originator and is not mandatory. It must not aim to bear any losses that would ordinarily be carried by credit enhancers or by the investors, and it must not be exercisable unless the outstanding amount of the original underlying portfolio of commercial paper issued is equal to or less than 10 per cent of the original amount.

Chapter VIII of the Banks Act<sup>111</sup> applies to an SPV that does not comply with the provisions of Securitisation Notice, 2008.<sup>112</sup> If the originator is a bank, non-compliance by that bank with the provisions of Securitisation Notice shall not necessarily mean that the SPV is also in non-compliance with the provisions of the notice. In other words, the originator and the SPV will be assessed independently to determine whether there was compliance with the provisions of the Notice.

### **6.3 BANKS ACT 94 OF 1990**

Chapter VIII of the Banks Act regulates the control of certain activities of persons not registered in terms of the Act.<sup>113</sup> The activities of an SPV that issues securities to the

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<sup>110</sup> Schedule, par 1.

<sup>111</sup> 94 of 1990.

<sup>112</sup> Schedule, par 17(2).

<sup>113</sup> In this par 'the Act' will refer to the Banks Act 94 of 1990.

public will fall within the meaning of ‘the business of a bank’ if they do not comply with Securitisation Notice, 2008. Therefore, the SPV will either have to register as a bank in terms of the Banks Act, or comply with the provisions of the Notice. Failing both, the Registrar of Banks has extensive powers and may apply to the High Court for an order to prohibit the continuation of activities contrary to the provisions of the Act and the Notice.<sup>114</sup> Alternatively, the Registrar may apply to the High Court for an order to prohibit the SPV from disposing or otherwise dealing with any of its assets while the contravention is being investigated.<sup>115</sup> The Registrar may require the SPV to supply such documents and information in writing relating to its affairs as specified and available to the SPV.<sup>116</sup>

If the Registrar is satisfied that the SPV carried on the business of a bank without being registered as a bank by contravening Securitisation Notice, 2008, the Registrar may direct the SPV to return any money received from the public through the issue of securities that has not yet been repaid, including interest and any other amounts owing.<sup>117</sup> Such repayment is subject to the provisions of section 84 of the Act. The Registrar may set requirements with regard to such payments and may impose time limits.<sup>118</sup>

When repayment is ordered in terms of section 83 of the Act, the SPV is not obliged to pay interest or any other amounts to its investors for the period after the repayment until the date when the claims of the issued securities would fall due.<sup>119</sup> This provision is peremptory and therefore any contrary agreement between the SPV and its investors, or in terms of the issue of the securities, will be subject to it.

The Registrar may appoint a person to manage and control repayment of the money in compliance with his directions.<sup>120</sup> The powers conferred upon an inspector

<sup>114</sup> Section 81(1)(i).

<sup>115</sup> Section 81(1)(iii).

<sup>116</sup> Section 82(1).

<sup>117</sup> Section 83(1).

<sup>118</sup> Idem.

<sup>119</sup> Section 83(2).

<sup>120</sup> Sections 84(1), 84(3) and 84(4)(d).

in terms of sections 4 and 5 of the Inspection of Financial Institutions Act<sup>121</sup> shall be applicable to such a manager.<sup>122</sup>

The manager must probe the affairs of the SPV in order to ascertain the amount of money obtained in contravention of Securitisation Notice, 2008, the persons to whom the money is owed, where the money or the assets into which the money was converted is kept or can be located, as well as any other fact that will facilitate repayment of the money.<sup>123</sup> He must take all steps necessary to expedite and ensure repayment of the money.<sup>124</sup> He must further report any offence committed by the SPV that comes to his attention.<sup>125</sup>

After a copy of the letter of appointment of the manager has been served on the SPV, the SPV may not dispose of, or otherwise deal with, its assets, except with the written permission of the manager.<sup>126</sup> In the context of securitisation, the manager will probably decide whether the servicing of the debts should continue unchanged or whether a new servicer should be appointed.

Refusal or failure to comply with a direction by the Registrar is an offence.<sup>127</sup> The SPV will then be deemed unable to pay its debts or to have committed an act of insolvency.<sup>128</sup> The Registrar may consequently apply for the winding-up of the SPV.

Both the SPV and the originator will be affected if section 83 is invoked by the Registrar. The SPV would have used the money raised from the issue of securities to pay for the transfer of the claims. As was explained above, the manager will have the authority to follow that money up in the hands of the originator and to reclaim it in order to repay the investors.

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<sup>121</sup> 80 of 1998.

<sup>122</sup> The Inspection of Financial Institutions Act 80 of 1998 provides for the inspection of the affairs of unregistered entities conducting the business of financial institutions. Section 4 provides for the powers of the inspector to interrogate persons, search the premises and seize documents of the institution under investigation. Section 5 provides for such powers with regard to institutions other than the one under investigation, but which may hold evidence relevant to the investigation of that institution.

<sup>123</sup> Section 84(4)(a).

<sup>124</sup> Section 84(4)(b).

<sup>125</sup> Section 84(4)(c).

<sup>126</sup> Section 84(2).

<sup>127</sup> Section 83(3)(a).

<sup>128</sup> Section 83(3)(b).

It is obvious that the provisions of Chapter VIII of the Act were not primarily designed to deal with the failure of a securitisation scheme to comply with the provisions of Securitisation Notice, 2008. These provisions aim to reverse transactions that contravene the Act. However, a securitisation scheme is so complex and there are so many role-players that it would be impossible to reverse it truly. Furthermore, the reputational cost to the originator in the event of such action by the Registrar will be extensive.

To date there has been no case where a securitisation scheme has been overturned by means of the provisions of Chapter VIII of the Banks Act 94 of 1990. However, these provisions are drastic and emphasise the need for careful structuring of a securitisation scheme so as to comply with Securitisation Notice, 2008.

### 6.3.1 Banks Amendment Act 20 of 2007

The Banks Amendment Act 20 of 2007 became operational on 1 January 2008. The Act mainly contains amendments necessitated by the revised Framework on International Convergence of Capital Measurement and Capital Standards published by the International Basel Committee.<sup>129</sup>

The Act defines a ‘traditional securitisation scheme’ with reference to the definition contained in Securitisation Notice, 2004, now repealed by Securitisation Notice, 2008. The definition remains unchanged in the new Notice.

The Act contains amendments to section 84 of the Banks Act,<sup>130</sup> which deals with the appointment of a manager by the Registrar to manage the affairs of an institution.<sup>131</sup> Experience has taught that once a manager is appointed under the provisions of section 84, the institution is invariably liquidated. Such a liquidation makes the efforts by the manager or inspector to reverse the illegal transactions worthless, and the higher fees charged by the appointed liquidator of the insolvent

<sup>129</sup> See the Memorandum on the Objects of the Banks Amendment Bill, 2007 at 2, available at [www.treasury.gov.za](http://www.treasury.gov.za) (accessed on 15 August 2007). The Framework on International Convergence of Capital Measurement and Capital Standards was published on 26 June 2004 and is available at [www.bis.org/publ/bcbs128b.htm](http://www.bis.org/publ/bcbs128b.htm) (accessed on 15 August 2007).

<sup>130</sup> 94 of 1990.

<sup>131</sup> See the discussion above. I shall assume that the institution is the SPV, but the provision is applicable to any institution that takes deposits from the general public without compliance with the provisions of the Banks Act 94 of 1990.

estate of the institution are to the detriment of the investors of such a scheme.<sup>132</sup> The amendment gives the Registrar the power to intervene.

As soon as practicable after his appointment, the manager must report to the Registrar whether the SPV is solvent, and if he finds that the SPV is insolvent, he must state whether it is a technical or a legal insolvency.<sup>133</sup> If the SPV is solvent, repayment of the investors will commence as set out in section 84.

If the report finds that the SPV is insolvent, the Registrar may apply for the winding-up of the SPV and he will have the right to oppose any application for the winding-up of the SPV by another person.<sup>134</sup> If the application for winding-up is successful, the Master must appoint the liquidator recommended by the Registrar,<sup>135</sup> subject to section 370 of the Companies Act.<sup>136</sup> This section implies that the wishes of the Registrar in the appointment of the liquidator will take precedence over the wishes of the trustee for debenture-holders and over other creditors of the SPV. The Registrar has the same rights as a creditor in the insolvency and winding-up of a company.<sup>137</sup>

The manager must recover and take control of all the assets of the SPV, subject to the direction of the Registrar,<sup>138</sup> regardless of whether the manager's report found the SPV to be solvent or insolvent. Since the assets of an SPV are claims, the manager will have to give notice to the debtors that the claims have been ceded to him by operation of law, with instructions on the person or institution appointed by him to collect payment of the claims. The manager will have to decide whether the original servicer will be retained or whether it is prudent to appoint another servicer in the particular circumstances.<sup>139</sup>

<sup>132</sup> Memorandum on the Objects of the Banks Amendment Bill, 2007 at 21.

<sup>133</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(a) in the Banks Act 94 of 1990.

<sup>134</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(c) in the Banks Act 94 of 1990.

<sup>135</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(d) in the Banks Act 94 of 1990.

<sup>136</sup> 61 of 1973. Section 370 empowers the Master to veto the recommendation of the creditors of a person to be appointed as a liquidator. If the Master and the creditors cannot agree on a suitable candidate, the Master will appoint a liquidator. See s 370(3)(b) of the Companies Act 61 of 1973. 'Creditor' here should read 'the Registrar' for purposes of s 84(1A) (d) of the Banks Act 94 of 1990.

<sup>137</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(f) in the Banks Act 94 of 1990.

<sup>138</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(b)(i) of the Banks Act 94 of 1990.

<sup>139</sup> See par 2.7.

On the appointment of the manager, all legal action against the SPV will be stayed and no person will be able to institute or proceed with legal action against the SPV without leave of a competent court.<sup>140</sup> Any application for leave to institute or proceed with legal action must also be served on the Registrar. The stay of legal proceedings will also follow regardless of the outcome of the report by the manager on the SPV's solvency.

It is clear that the ability of the trustee for debenture-holders to institute proceedings, including an application for the winding-up of the SPV, is curtailed by these provisions. However, it is possible that the Registrar may find that the trustee is a suitable person to act as the manager of the SPV under these circumstances. It is further possible that the trustee and the Registrar may agree as to whom should be appointed as the liquidator, should the SPV be liquidated. Both these situations are preferable above bringing a third party into the management of the scheme. It might be advisable to include in any future amendments to Securitisation Notice a proviso to paragraph 17(2) of the Schedule, which reads:

- (a) If a trustee for debenture-holders was appointed under the scheme, the Registrar shall consult the trustee before he takes any action in terms of Chapter VIII.

## 6.4 NATIONAL CREDIT ACT 34 OF 2005

The South African Department of Trade and Industry devised a legislative framework to address consumer protection issues, which resulted in the National Credit Act 34 of 2005<sup>141</sup> and the draft Consumer Protection Bill, 2006.<sup>142</sup> The National Credit Regulator (NCR) has the power to enforce the National Credit Act<sup>143</sup> and to oversee the development of the South African credit market in a manner that is consistent with the purposes of the Act.<sup>144</sup>

<sup>140</sup> Section 28 of the Banks Amendment Act 20 of 2007, inserting s 84(1A)(b)(ii) of the Banks Act 94 of 1990.

<sup>141</sup> The last sections of the Act commenced on 1 June 2007. The Act consolidates previous regulation of consumer credit by repealing the Usury Act 73 of 1968 and the Credit Agreements Act 75 of 1980. Furthermore it reflects the influence of the Constitution, especially the Bill of Rights, by making provision for the consumer's access to improved information and his protection against discriminatory practices.

<sup>142</sup> GN 418, GG 28629, 15 March 2006. A second draft appeared on 21 September 2006, but it was not available for public comment. A copy of the second draft is available at [www.thedti.gov.za](http://www.thedti.gov.za) (accessed 14 August 2007).

<sup>143</sup> Section 15. See also Pieter Jordaan *The Credit Law of South Africa: A Guide to Consumers, Credit Users and Credit Grantors* (2007) at 37.

<sup>144</sup> Section 13. All references in this par to 'the Act' refers to the National Credit Act 34 of 2005.

The provisions of the National Credit Act are important when discussing securitisation, because the debtors of the claims transferred to an SPV will often fall under the definition of ‘consumer’ in respect of a credit agreement to which the Act applies.<sup>145</sup>

In my opinion, adequate consumer protection and responsible lending practices are key factors in ensuring the long-term viability of securitisation as a financing method. The SPV is dependent on the income from the transferred claims to service payments on its issued securities and the other expenses associated with the scheme. If the debtors of those claims were misled about the extent of their obligations in terms of the agreement, or if they were granted credit when they could not afford it, they might not be able to subsequently perform in terms of the agreement. Isolated instances of unfair consumer practices might not pose a problem to a securitisation scheme. However, if these practices are widespread the quality of the debtor base that must support the securitisation scheme might become poor.<sup>146</sup> This could, in turn, be an

<sup>145</sup> Section 1 defines ‘consumer’, in respect of a credit agreement to which the Act applies, as “(a) the party to whom goods or services are sold under a discount transaction, incidental credit agreement or instalment agreement; (b) the party to whom money is paid, or credit granted, under a pawn transaction; (c) the party to whom credit is granted under a credit facility; (d) the mortgagor under a mortgage agreement; (e) the borrower under a secured loan; (f) the lessee under a lease; (g) the guarantor under a credit guarantee; or (h) the party to whom or at whose direction money is advanced or credit granted under any other credit agreement.” Section 8 describes the credit agreements to which the Act applies. Insurance policies, leases of immovable property and transactions under a *stokvel* are specifically excluded, but most other credit agreements fall under the ambit of the Act. In terms of the Act, consumers are not only natural persons, but also juristic persons below a specified threshold in asset value and annual turnover (s 4(1)(a)). The threshold is capped at R1 million (s 7(1)). However, the provisions relating to credit market practices (ch 4 Part C), over-indebtedness and reckless credit (ch 4 part D) and the consumer’s liability, interest charges and fees (ch 5 Part C) do not apply where the consumer is a juristic person (s 6). Deferred payments and terms of 30 days do not qualify as credit agreements under the Act (s 4(6)(b)).

<sup>146</sup> See Peterson in Whitford *et al Consumer Credit* (forthcoming 2009). Peterson shows that poor consumer protection measures in the USA contributed to the current crisis in the subprime lending industry. The ‘subprime market’ refers to loans extended to borrowers who do not have good credit records and consequently do not qualify for assignment to the government-sponsored enterprises. See ch 3. The author argues that securitisation is a contributing reason for the crisis in that lenders immediately transfer their risk thereby reducing the risk of poor lending practices. It appears to me that securitisation as a financing form stands nothing to gain from inadequate consumer protection. It is already evident that securitisation schemes that were recipients of claims originating from such practices are under pressure in the USA. The problem, in my opinion, rests not with securitisation as a concept, but with an inadequate regulatory framework for consumer protection. Peterson further argues that the large stake that Wall Street has in the securitisation market means that political pressure is put on state legislatures not to enact more stringent consumer protection legislation. I shall not venture into the mechanics of legal decision making in the USA, but it should be noted that securitisation is probably not the only benefactor of such political pressure. Peterson mentions some policies as examples of how securitisation and poor consumer protection can reinforce each other. They are (1) ‘Teaser interest rates’ whereby very favourable interests rates are offered to consumers initially, but the rate will steadily increase over time. Before the interest rate becomes unbearable for the consumer, the loan is securitised by the credit provider. (2) Mortgage brokers are paid through



obstacle in obtaining the rating that the scheme aims for and will definitely increase the costs of credit enhancement.

The three key purposes of the Act that will influence lending practices, and by implication securitisation, are

- 1 promoting responsibility in the credit market by<sup>147</sup>
  - encouraging responsible borrowing, avoidance of over-indebtedness and fulfillment of financial obligations by consumers; and
  - discouraging reckless credit granting by credit providers and contractual default by consumers;
- 2 promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers;<sup>148</sup>
- 3 addressing and preventing over-indebtedness of consumers, and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by consumers of all responsible financial obligations.<sup>149</sup>

#### 6.4.1 Over-indebtedness and reckless credit

The concepts of over-indebtedness and reckless credit go hand in hand in the context of the National Credit Act.

A consumer is over-indebted if at the time that the determination is made the preponderance of available information shows that the consumer will not be able to satisfy in a timely manner all his obligations under all the credit agreements to which he is a party.<sup>150</sup> The consumer's financial means, prospects and obligations must be taken into account,<sup>151</sup> as well as his history of debt repayment.<sup>152</sup>

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commissions on the number and size of the loans that they can sell. This creates an incentive to deceive consumers about the terms of their credit agreements. Originators sell the loans through securitisation before default can harm their enterprises. (3) Mortgage brokers conceal to consumers that they will receive commission if they can negotiate an 'above par' loan. An 'above par' loan is where the borrower agrees to a more costly loan than he actually qualifies for based on what the lender offers other borrowers.

<sup>147</sup> Section 3(c). See also JM Otto *The National Credit Act Explained* (2006) at 6.

<sup>148</sup> Section 3(d)

<sup>149</sup> Section 3(g).

<sup>150</sup> Section 79(1); Jordaan *Credit Law* at 56; Otto *NCA Explained* at 54.

<sup>151</sup> Section 79(1)(a).

<sup>152</sup> Section 79(1)(b).

The Act makes it compulsory for a credit provider to take reasonable steps to assess a prospective consumer's general understanding and appreciation of the risks, and the costs of the proposed agreement, as well as of the consumer's rights and duties under the agreement.<sup>153</sup> There must also be an assessment of the prospective consumer's debt-repayment history under other credit agreements and of the consumer's existing financial means, prospects and obligations.<sup>154</sup>

Evidently this assessment is dependent on adequate and truthful disclosure by the prospective consumer. It is therefore a complete defence to an allegation that a credit agreement was reckless if the credit provider can show that the consumer failed to fully and truthfully answer any requests for information made during the assessment and the court or tribunal finds that the failure to do so materially affected the ability of the credit provider to make a proper assessment.<sup>155</sup> In other words, the consequence of a failure by a consumer to make a full and truthful disclosure is that he will not be protected under the reckless credit provisions in the Act. The application forms of most large credit providers now carry a notice to the consumer to this effect before the assessment section.

The credit agreement will immediately be reckless in terms of the Act if this assessment is not carried out.<sup>156</sup> If the assessment was carried out and the credit provider extended credit to the consumer when the information available to the credit provider showed that the consumer did not generally understand or appreciate the risks, costs or obligations under the agreement, or if the information showed that entering into the agreement would make the consumer over-indebted, the credit agreement will be reckless.<sup>157</sup> The position of the consumer at the time of entering into the agreement is relevant here and not his position at the time of the determination.<sup>158</sup>

If the court finds that a credit agreement is reckless because the credit providers did not make the required assessment of the prospective consumer or because the

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<sup>153</sup> Section 81(2)(a)(i). See also Otto *NCA Explained* at 40.

<sup>154</sup> Sections 81(2)(a)(ii) and (iii). The credit provider may determine its own assessment mechanisms or models and procedures to evaluate the prospective consumer's suitability (s 82). The NCR may publish guidelines in this regard, but they are not binding (ss 82(2)(b) and 82(3)). The credit provider may also obtain pre-approval by the NCR of their particular assessment mechanisms, which is the preferred approach to achieve legal certainty (s 82(2)(a)).

<sup>155</sup> Section 82(4); Jordaan *Credit Law* at 59; Otto *NCA Explained* at 66–67.

<sup>156</sup> Section 80(1)(a); Jordaan *Credit Law* at 57; Otto *NCA Explained* at 66.

<sup>157</sup> Section 80(1)(b).

<sup>158</sup> Section 80(2).

consumer did not understand the risks, costs or obligations flowing from the agreement, the court may make one of two possible orders. First, the court may order that all or a part of the consumer's rights or duties under the agreement must be set aside in a manner that the court determines just and reasonable. Alternatively, the court may order that the force and effect of the agreement be suspended.<sup>159</sup>

If the court finds that a credit agreement is reckless because it left the consumer over-indebted after entering into the agreement, the court must first consider whether the consumer is in fact over-indebted at the time of the proceedings.<sup>160</sup> Should the court find that the consumer is over-indebted it may suspend the force and effect of the credit agreement until a date determined by it.<sup>161</sup> The court may further order that any other credit agreements of the consumer must be restructured.<sup>162</sup> The consumer's current means and the expected date by which the consumer will have satisfied the outstanding obligations under a credit agreement are factors that will influence the court's order.<sup>163</sup>

There is therefore a very real possibility that the court may suspend the credit agreement if it makes a finding that credit was extended recklessly. During the suspension period the consumer is not required to make any payment under the agreement,<sup>164</sup> nor is the credit provider allowed to charge any interest, fee or any other charges under the agreement.<sup>165</sup> Despite any law to the contrary, the credit provider's rights under the agreement and in terms of any law in respect of the agreement are unenforceable.<sup>166</sup>

If such a claim was part of a securitisation scheme, there will be no income forthcoming from that claim until the suspension ends. Of course, if only a few claims transferred to the SPV become non-performing, for whatever reason, the scheme will not be dramatically affected. Such non-performance is already catered for by way of the credit enhancements built into the scheme. However, if there is large scale non-

<sup>159</sup> Section 83(2); *Otto NCA Explained* at 67. See below for the effects of such a suspension.

<sup>160</sup> Section 83(3)(a).

<sup>161</sup> Section 83(3)(b)(i); *Jordaan Credit Law* at 59; *Otto NCA Explained* at 67.

<sup>162</sup> Section 83(3)(b)(ii).

<sup>163</sup> Section 83(4).

<sup>164</sup> Section 84(1)(a).

<sup>165</sup> Section 84(1)(b); *Jordaan Credit Law* at 59.

<sup>166</sup> Section 84(1)(c).

adherence to the provisions of the Act that leads to many suspensions, the scheme may be adversely affected.

Whereas ‘reckless credit’ refers to a particular credit agreement, ‘over-indebtedness’ refers to the consumer’s overall ability to fulfil his obligations in a timely manner. There are three available ways in which a consumer can be declared over-indebted: the consumer can approach a debt counsellor to review his debt situation,<sup>167</sup> or if this failed, he can approach the court directly for an order to be declared over-indebted, or it may be that the over-indebtedness of the consumer is alleged in court while a reckless credit agreement is under consideration.

Usually, the consumer will visit a debt counsellor first. The debt counsellor will evaluate information received from the consumer and from the credit providers that extended credit to the consumer to decide whether the consumer is over-indebted.

If the consumer is not over-indebted, but experiences problems satisfying all his obligations in a timely manner, the debt counsellor can recommend that the consumer and the credit providers enter into a voluntary debt rearrangement.<sup>168</sup> If the debt counsellor finds that the consumer is over-indebted, he may issue a proposal recommending that the court declare one or more of the credit agreements reckless and/or that one or more of the consumer’s obligations be rearranged.<sup>169</sup> Such a rearrangement can take four possible forms:<sup>170</sup>

- 1 The period of the agreement can be extended, thereby reducing the amount payable in each instalment.
- 2 Payments can be postponed for a specified period.
- 3 The period of the agreement can be extended and the payments due can be postponed for a specified period.

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<sup>167</sup> Section 86; *Jordaan Credit Law* at 60–61; *Otto NCA Explained* at 54–55.

<sup>168</sup> Section 86(7)(b); *Jordaan Credit Law* at 62; *Otto NCA Explained* at 55. A voluntary debt rearrangement recommendation can be referred to the court by the debt counsellor if the consumer and his credit providers cannot reach an agreement. The court will then consider the matter in terms of s 87(1).

<sup>169</sup> Section 86(7)(c).

<sup>170</sup> Sections 86(7)(c)(ii)(aa)–(dd).

- 4 The consumer's obligations under the credit agreement could be recalculated because of contraventions of Parts A and B of Chapter 5, or Part A of Chapter 6 of the Act.<sup>171</sup>

The second manner in which a consumer can be declared over-indebted is by approaching the court directly. This will follow when the debt counsellor did not find the consumer to be over-indebted. The consumer may then apply for leave to approach the court directly. After considering the matter, the court may declare a particular credit agreement reckless and/or order the re-arrangement of the consumer's obligations in the manner set out above.<sup>172</sup>

A consumer can, in the third instance, be declared over-indebted when his over-indebtedness is alleged during proceedings where a specific credit agreement is being considered. In such an event, the court may refer the matter to a debt counsellor who will proceed in the manner described above.<sup>173</sup> Otherwise, the court may declare the consumer over-indebted without intervention of a debt counsellor and make an order to declare a credit agreement reckless or to re-arrange the consumer's obligations.<sup>174</sup>

During the review of the consumer's debts by a debt counsellor or by the court the consumer is not allowed to incur any further charges under existing credit agreements or to enter into any new credit agreements.<sup>175</sup> If a consumer applies for, or enters into, a credit agreement in contravention of this prohibition, the protection of the Act will not be available to the consumer in respect of that agreement.<sup>176</sup> A credit agreement entered into while the consumer was subject to a debt rearrangement might be declared wholly or partially reckless, regardless of whether the normal test for reckless credit in the Act applies to that agreement.<sup>177</sup>

In conclusion, it appears that securitisation can only be adversely affected by the provisions of the Act on reckless credit and over-indebtedness provisions if

<sup>171</sup> Part A of ch 5 deals with unlawful credit agreements and unlawful provisions in credit agreements. Part B of ch 5 regulates the disclosures necessary when entering a credit agreement, as well as the prescribed form and effect of credit agreements. Part A of ch 6 regulates the collection and repayment practices of credit providers.

<sup>172</sup> Section 87(1)(b).

<sup>173</sup> Section 85(a).

<sup>174</sup> Section 85(b).

<sup>175</sup> Section 88(1).

<sup>176</sup> Section 88(5).

<sup>177</sup> Section 88(4).

originators are lax in the manner in which they extend credit. Guarding against over-indebtedness might actually be beneficial to securitisation in the long run, because default patterns of debtors may become more predictable as a result. The Act requires lenders to be vigilant in their assessment of borrowers' ability to meet their commitments in terms of the credit agreements they enter. This should provide lenders with a better chance of judging the risk they take in extending credit to the particular borrower. It also enhances the chances that the borrower will be able to fulfill his duties through the course of the credit agreement. The certainty with which a securitisation transaction is structured, especially when it comes to the amount of credit enhancement necessary to support the risk of default on the transferred claims, is increased when reliable data is available on the creditworthiness of the debtors.

#### **6.4.2 Unlawful credit agreements**

It is unlawful in terms of the Act for a credit provider to make an offer for credit to a consumer and to state that the offer will become binding unless the consumer declines it specifically.<sup>178</sup> It is further unlawful for a credit provider to extend credit, make it available or to offer credit when the credit provider is subject to a notice by the National Credit Regulator to stop such functions pending further action.<sup>179</sup> Agreements entered into under these circumstances are unlawful credit agreements.<sup>180</sup> If the credit provider enters into a supplementary agreement that will have the same effect as an unlawful credit agreement, the supplementary credit agreement will also be unlawful.<sup>181</sup>

An unlawful credit agreement is void from the date on which it was entered into.<sup>182</sup> All money paid by the consumer to the credit provider in terms of such an agreement must be refunded to the consumer with interest.<sup>183</sup> All rights of the credit provider in terms of the agreement to recover money from the consumer are either cancelled or forfeited to the State, depending on the court's finding of whether cancellation would

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<sup>178</sup> Section 74(1).

<sup>179</sup> Section 89(2)(e).

<sup>180</sup> Section 89.

<sup>181</sup> Section 91(a). On unlawful credit agreements generally, see *Otto NCA Explained* at 42 *et seq.*

<sup>182</sup> Section 89(5)(a); *Jordaan Credit Law* at 64; *Otto NCA Explained* at 42–43.

<sup>183</sup> Section 89(5)(b).

unjustly enrich the consumer.<sup>184</sup> These consequences will definitely deter credit providers from engaging in the prohibited practices.

The Act further sets out certain provisions in credit agreements that will be considered unlawful.<sup>185</sup> The gist of these provisions is that the credit agreement may not circumvent the Act in any manner. An unlawful provision in a credit agreement will be severed from the rest of the agreement if possible, or if not possible, the whole agreement may be declared unlawful.<sup>186</sup>

The consequences of a finding that a credit agreement is unlawful are dire. However, the typical credit provider that enters a securitisation scheme as originator will have ample resources at its disposal to ensure that it offers and extends credit in the prescribed manner. I therefore do not foresee that these provisions will have a significant impact on securitisation. Furthermore, defects in the lending practices of the originator will hopefully be recognised by the rating agency involved in the structuring of the scheme. These considerations therefore introduces additional factors that rating agencies must keep in mind during their assessment.

### 6.4.3 Registration as credit provider

The National Credit Regulator confirmed in a telephonic interview<sup>187</sup> that after extensive consultation with interested parties all potential difficulties surrounding compliance with the requirements of the Act in the context of securitisation schemes have been settled. Essentially the National Credit Regulator is satisfied as long as the transaction agreements clearly stipulate which parties to the scheme will register as credit providers.

However, deciding who ought to register as credit providers is easier said than done. One must remember that in terms of Securitisation Notice, 2008, all rights and obligations of the originator must be transferred to the SPV. It follows that the relevant relationship that one looks at to decide whether a party is a credit provider is that between the current legal holder of the claim and the debtor of the claim. In other words, if the originator was a credit provider who had to register as such, which is mostly the case, and it transfers the claim to the SPV by way of cession, or by cession

<sup>184</sup> Section 89(5)(c).

<sup>185</sup> Section 90; Jordaan *Credit Law* at 64–67; Otto *NCA Explained* at 43–46.

<sup>186</sup> Section 90(4).

<sup>187</sup> With the author, October 2007.

and delegation, the SPV will step in the shoes of the original credit provider and will have to register as a credit provider.

A ‘credit provider’ in respect of a credit agreement to which the Act applies,<sup>188</sup> is defined in the Act as<sup>189</sup>

- (a) the party who supplies goods or services under a discount transaction, incidental credit agreement or instalment agreement;
- (b) the party who advances money or credit under a pawn transaction;
- (c) the party who extends credit under a credit facility;
- (d) the mortgagee under a mortgage agreement;
- (e) the lender under a secured loan;
- (f) the lessor under a lease;
- (g) the party to whom an assurance or promise is made under a credit guarantee;
- (h) the party who advances money or credit to another under any other credit agreement; or
- (i) any other person who acquires the rights of a credit provider under a credit agreement after it has been entered into

From this definition it is apparent that the SPV will need to register as a credit provider. This is because the originator would usually be a credit provider in terms of (a) to (h) of the definition and the SPV acquires the rights of the credit provider after it has been entered into, which falls under (i) of the definition.

What is less clear is whether the trustee for debenture-holders or the security SPV<sup>190</sup> will also need to register as a credit provider. Since non-compliance with the registration requirement will leave the underlying credit agreements to be classified as unlawful agreements and void in terms of section 89,<sup>191</sup> it is safest simply to register the trustee for debenture-holders or security SPV as a credit provider.<sup>192</sup>

From a theoretical point of view it is only necessary for the trustee for debenture-holders or security SPV to immediately register as a credit provider if the securities issued by the SPV are secured by way of fiduciary security cession. In this form of security the claims will be ceded to the trustee for debenture-holders or security SPV, who then acquires the rights of a credit provider as defined in (i) above. The SPV does not retain these rights when this form of security is used, but only has a

<sup>188</sup> Section 8 sets out what constitutes a credit agreement for purposes of the Act. Most transactions that give rise to the claims regularly transferred during securitisation schemes will fall under the ambit of s 8.

<sup>189</sup> Section 1. *Otto NCA Explained at 12* summarises this definition as follows: “A credit provider is the grantor of credit, or the cessionary of a credit grantor”.

<sup>190</sup> See the discussion in par 2.8.2.

<sup>191</sup> Section 40(4). See also par 6.4.2 above on the effects of s 89.

<sup>192</sup> Registration is not an onerous process and the application process need not be completed for the scheme to proceed.



reversionary interest that the remaining claims will be receded to it after it had complied with its obligations in terms of the issued securities.

If a pledge of claims is used as a form of security, the duty to register as a credit provider will only arise after the default of the SPV. During a pledge of claims the power to realise the claim is transferred to the pledgee, but this power may only be exercised by the pledgee after default by the pledgor. The claim itself remains in the estate of the pledgor. The pledgee will, in my opinion, not acquire the rights of a credit provider as set out in (i) above before it is entitled to realise the claims in terms of the pledge. Furthermore, if the securitisation scheme goes as planned this power will not become effective at all, which would make the registration of the trustee or security SPV as credit provider superfluous.

If a general notarial bond is used as security, the trustee or security SPV will only acquire the rights of a credit provider after perfection of the bond, which in the case of claims will be after notice is given to debtors. Until then the SPV will continue to collect the claims for its own account through its appointed servicer. The trustee or security SPV will not have acquired the rights of a credit provider as stipulated in the Act.

## 6.5 COMPANIES ACT 61 OF 1973

The Companies Act 61 of 1973 applies to an originator and an SPV if they are companies, except for provisions in the Act that are only applicable to specific types of companies. Here the focus is on aspects of the Act that might be overlooked during securitisation.<sup>193</sup> Provisions in the Act that relate to the limitation of the capacity of the SPV to engage in activities other than those associated with the securitisation scheme and the limitation of the powers of the directors of the company to engage in such activities, were discussed in Chapter 2 and are not repeated here.<sup>194</sup> The provisions of the Act that deal with the issue of debentures were considered in detail in Chapter 5 and are also not repeated in this chapter.<sup>195</sup>

<sup>193</sup> All references in this par to 'the Act' refer to the Companies Act 61 of 1973.

<sup>194</sup> See par 2.3.

<sup>195</sup> See par 5.2.

### 6.5.1 Provisions of Companies Act 61 of 1973 that are important for originator

In modern companies there is usually a clear separation of powers between the management of the company and its membership.<sup>196</sup> The board of directors is usually given the power in the articles of association of the company to manage the company and to take the day to day decisions in the running of its business. The members, as represented in the general meeting, have a supervisory role in that they can remove the directors if they are not satisfied with the manner in which the company is run.<sup>197</sup> They do not have the power to intervene in decisions that fall within the scope of the powers of the board of directors.<sup>198</sup>

The decision of a company to transfer some of its assets under a securitisation scheme is a business decision, which will fall under the authority of the board of directors of the originator. However, the directors do not want to send a confusing message about the prospects of the company to the greater investor public. Consequently it will be prudent for the board of directors to provide enough information to its members about the proposed scheme as is necessary to guard the company against speculation and negative sentiment. It must be remembered that while the investors in the securities issued by the SPV will usually be sophisticated, the same is not necessarily true of the investors in the originator. Securitisation is a relatively new financing form in South Africa and will be new to many of the originator's investors.<sup>199</sup>

#### 6.5.1.1 Disposal of undertaking or greater part of assets of company

The approval of the general meeting is necessary if the transfer of the assets to the SPV will constitute a disposal of the undertaking of the originator or a disposal of the greater part of the assets of the originator.<sup>200</sup> 'Dispose' has its ordinary meaning of "to

<sup>196</sup> See Cilliers *et al Corporate Law* at 86 *et seq*; Meskin *et al Henochsberg* at 327.

<sup>197</sup> Section 220 of the Companies Act 61 of 1973 provides that directors can be removed by way of an ordinary resolution of the members of a company.

<sup>198</sup> *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 at 134: "[The general body of shareholders] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders."

<sup>199</sup> See also my comments in par 2.2.6.3.

<sup>200</sup> Section 228(1)(a) and (b): "Notwithstanding anything contained in its memorandum, or articles, the directors of a company shall not have the power, save by a special resolution of its members, to dispose of – (a) the whole or the greater part of the undertaking of the company; or (b) the whole of

part with” or “to get rid of”. Only a disposal that permanently deprives a company of its ownership of the assets falls within the ambit of this section.<sup>201</sup> It is the aim of traditional securitisation to permanently divest the originator of its rights to the transferred assets.

The approval of the general meeting must be obtained before implementation of the disposal, not necessarily before the agreement to dispose is entered into. If the agreement to dispose was entered into without the approval of the shareholders it is not void, because the shareholders may still ratify the agreement to dispose.<sup>202</sup> However, such an agreement is voidable; otherwise the purchaser has an action for damages against the company which will leave the shareholders with no option but to ratify.<sup>203</sup>

Some securitisations may fall under the ambit of section 228, as there is no bar in theory to the type of asset that may be used in securitisation, nor to the size or extent of the assets that may be transferred by the originator to the SPV.

Previously an ordinary resolution by the general meeting was adequate to approve such a disposal. This gave rise to certain problems. An ordinary resolution by the general meeting of a company is not filed with the Registrar of Companies. A purchaser of assets in contravention of section 228 could argue that he assumed that the company obtained the required permission to dispose of the assets and rely on the *Turquand* rule to keep the company from denying the disposition.<sup>204</sup>

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the greater part of the assets of the company.” On s 228 generally, see Blackman *et al Commentary* at par 8-325 *et seq*; Meskin *et al Henochsberg* at 441 *et seq*.

<sup>201</sup> Meskin *et al Henochsberg* at 442; Blackman *et al Commentary* at par 8-325.

<sup>202</sup> See *Ally and Others NNO v Courtesy Wholesalers (Pty) Ltd* 1996 (3) SA 134 (N) at 145E–G.

<sup>203</sup> Blackman *et al Commentary* at par 8-326.

<sup>204</sup> *Royal British Bank v Turquand* (1856) 6 E & B 327. The rule was formulated by the English courts in order to limit a third party’s duty to make inquiries into matters that formed part of public record. In terms of the rule a third party acting in good faith may assume that the internal requirements and procedures required for the granting of authority have been complied with. Reliance on the *Turquand* rule entails that the company is bound to the transaction, even though the internal requirements were not met. For arguments for and against the application of the *Turquand* rule to this effect see PEJ Brooks “Section 228 of the Companies Act: *Levy v Zalrut Investments (Pty) Ltd*” (1987) 50 *THRHR* 226 (the Court in *Levy* held in an *obiter dictum* that the *Turquand* rule could protect a *bona fide* third party); Michele von Willich “Die Uitwerking van a 228 van die Maatskappywet 61 van 1973” (1988) 10 *Modern Business Law* 7; JSA Fourie “Verkoop van die Onderneming van die Maatskappy: Het Artikel 228 van die Maatskappywet nog Betekenis?” (1992) *TSAR* 1; Basil Wunsh “Section 228 of the Companies Act and the *Turquand* Rule” (1992) *TSAR* 545; JS McLennan “Section 228 of the Companies Act and the *Turquand* Rule” (2005) 68 *THRHR* 305. See also *Farren v Sun Service SA Photo Trip Management (Pty) Ltd* 2004 (2) SA 146 (C) at 155C where the Court held that the *Turquand* rule could not operate to defeat the object of the

In view of these concerns, section 228 was amended. A special resolution by the general meeting of the company is now required to consent to the disposal of the undertaking or of the greater part of the assets of the company.<sup>205</sup> A special resolution must be registered with the Registrar of Companies to take effect and therefore provides third parties with notice of the consent, or the lack thereof.<sup>206</sup> The *Turquand* rule will be of no further use to a third party, because the compliance of the requirement of consent will be easily ascertainable from the public documents. The general meeting must consider the specific transaction and cannot give a blanket approval.<sup>207</sup> The value of the assets or the undertaking, and the value of the disposed part, must be determined with reference to the fair value of the assets as indicated by the financial reporting standards.<sup>208</sup>

If the securitisation scheme is a disposal in terms of section 228, it will be an affected transaction in terms of section 440A(2)(c).

#### 6.5.1.2 Affected transactions

An ‘affected transaction’ means any transaction (including a transaction which forms part of a series of transactions) or scheme, whatever form it may take, which will vest control in a person, or persons acting in concert, that did not have control before the scheme was implemented, or consolidating such control, or which will make a person the sole holder of all the securities of the company or of all the securities of a particular class.<sup>209</sup> ‘Control’ is further defined in the Act as holding the specified percentage or more of the voting rights at meetings of the company. The specified percentage is currently set at 35 per cent or more of the voting rights in a company.<sup>210</sup>

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legislature to protect shareholders against such disposals. See further Meskin *et al Henochsberg* at 441–442; Blackman *et al Commentary* at par 8-326-1 to 8-326-4.

<sup>205</sup> Section 228(1)(a) and (b), as amended by the Corporation Laws Amendment Act 24 of 2006.

<sup>206</sup> Sections 199, 200, 202 and 203.

<sup>207</sup> Section 228(3).

<sup>208</sup> Section 228(4). In *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W) at 145F–G it was held that the value of the assets is their market value. ‘Market value’ refers to the price that the assets would fetch in a *bona fide* sale between a willing buyer and a willing seller, who are both well informed about the transaction, neither of whom is under extraordinary pressure to buy or sell. I submit that this is a fair representation of market value and that the applicable financial reporting standards will probably only build on it from a financial point of view.

<sup>209</sup> Section 440A.

<sup>210</sup> Section B, par 5 of The Securities Regulation Code on Take-Overs and Mergers. The definition of ‘affected transaction’ in the Companies Bill 61 of 2008 does away with the focus on control and makes no mention of a specified percentage. See cl 117(1)(c) of the Companies Bill 61 of 2008.

The implementation of a traditional securitisation scheme will not be an affected transaction in terms of the Companies Act, unless it is a disposal as contemplated in section 228.

If the scheme entails such a disposal, the Securities Regulation Panel on Take-Overs and Mergers will regulate the scheme in such a manner as it deems necessary and appropriate.<sup>211</sup> Rule 29(d) of the Securities Regulation Code on Take-Overs and Mergers grants the Panel the right in its sole and absolute discretion to direct any shareholder that he may not vote at the meeting where the disposal is to be considered and that his votes may not be exercised in whole or in part. The Panel will give such an instruction if the vote of that shareholder will result in an inequity to any other shareholder due to a direct or indirect conflict of interest. Although Rule 29 does not limit its application and may be applied to other persons, the shareholder in question will usually be the person who offered to purchase the assets or the undertaking of the company. The idea behind the provision is that minority shareholders would be afforded the opportunity to stop the disposal or have some influence on the terms of the disposal.<sup>212</sup>

The inclusion of a disposal under section 228 in the definition of an ‘affected transaction’ is inconsistent with the rest of the definition and the general functions of the Securities Regulation Panel.<sup>213</sup> The Panel usually considers a transaction where there is an acquisition or a consolidation of control in the company, and which has bearing on the securities issued by the company.

Luiz<sup>214</sup> argues that a company that intends to dispose of substantially all of its assets or undertaking will not comply with the definition of ‘offeree company’ in the Code. Section B of the Code defines ‘offeree company’ as “any company the securities or part of the securities of which are or are to be the subject of any affected transaction or proposed affected transaction”. No securities of the company are the subject of a disposal in terms of section 228. This creates uncertainty over the

<sup>211</sup> Section 440C(1)(a).

<sup>212</sup> SM Luiz *An Evaluation of the South African Securities Regulation Code on Takeovers and Mergers* (2003 thesis UNISA) at 612 and 614; SM Luiz “Some Comments on the Definition of an ‘Affected Transaction’ in the Companies Act” (2004) 16 *SA Merc LJ* at 13; Meskin *et al Henochsberg* at 443; Blackman *et al Commentary* at par 8-326-5.

<sup>213</sup> Luiz *Evaluation* at 612–613; Luiz 2004 *SA Merc LJ* at 11–12.

<sup>214</sup> *Evaluation* at 614; Luiz 2004 *SA Merc LJ* at 13.

applicability of the Code to such transactions, because the Code only applies to companies that fall under the definition of ‘offeree company’.<sup>215</sup>

It appears as if a disposal in terms of section 228 was included in the definition of ‘affected transaction’ as an afterthought. The processes envisaged by the Code are not suitable to investigate or regulate such a disposal. I therefore agree with Luiz that it would be more suitable to amend section 228 to include protection for minority shareholders than to try to fit disposals in with affected transactions.<sup>216</sup>

### 6.5.1.3 Conflicts of interest

Securitisation Notice, 2008 restricts the originator in the number of shares it may hold in the SPV and in the power it may have in the voting of the general meeting of the SPV. However, the notice is silent on the ability of directors of the originator to be members of the SPV. Consequently, it is possible for a director of the originator to be a controlling member of the SPV. It is further possible for a director to have interests in the third parties involved in the scheme, such as the servicer, trustee or one of the credit enhancers. In some cases where securitisation was associated with fraud lax controls over conflicts of interest were one of the elements identified as leading to abuse.<sup>217</sup>

A director must disclose any material interest that he directly or indirectly has in a proposed contract by the company, or in which he becomes materially interested after the contract was entered into.<sup>218</sup> The interest and its full particulars must be disclosed. The contract or proposed contract must be of significance to the business of the company and must be entered into in pursuance of a resolution taken by the board of directors or by an authorised director.<sup>219</sup> A securitisation scheme will always qualify as significant to the business of the company and will be initiated by resolutions of the

<sup>215</sup> Luiz 2004 *SA Merc LJ* at 13 argues that the Code does not apply at all to disposals by companies, nor is she in favour of an amendment of the definition of ‘offeree company’ to include such disposals (see also Luiz *Evaluation* at 615). Meskin *et al Henochsberg* at 966 agrees with this view.

<sup>216</sup> Luiz 2004 *SA Merc LJ* at 14. Luiz *Evaluation* at 616 argues in favour of the removal of such disposals under the definition of ‘affected transaction’ and consequently from the supervision of the Panel. See also my discussion of the Companies Bill 61 of 2008 in par 6.6.4.

<sup>217</sup> See in this regard Schwarcz 2002 *Univ of Cincinnati LR* at 1316–1317, where he discusses the abuses that lead to the Enron collapse.

<sup>218</sup> Section 234(1). See also Meskin *et al Henochsberg* at 445; Blackman *et al Commentary* at par 8-329 to 8-338.

<sup>219</sup> Section 234(2).

board of directors of the originator. Failure by a director to disclose such an interest in a contract is an offence.<sup>220</sup>

A resolution by the board of directors to whom the appropriate disclosures of conflicts of interest were not made is invalid.<sup>221</sup> If the articles of association of the company do not contain a clause that allows directors to enter into contracts with the company, a so-called exclusion clause, the approval by the general meeting for such actions must be obtained additionally before the transaction may go ahead.<sup>222</sup> Otherwise the transaction is voidable at the option of the company.<sup>223</sup>

The company must keep a register of declarations of interests in contracts.<sup>224</sup> The company's auditor must verify the register's content.<sup>225</sup>

The board of directors of the originator must be vigilant when it comes to identifying a conflict of interests during a securitisation scheme. The structure of the scheme may be very complicated, which can aid a corrupt director to mislead others about his indirect involvement.

#### 6.5.1.4 Company secretary

A public company having a share capital must appoint a company secretary.<sup>226</sup> One of the duties imposed on a company secretary is to advise the directors on the law and legislation relevant to, or affecting, the company.<sup>227</sup> This will include all law and legislation relating to the company's role during a securitisation of its assets. Whereas specialist advice is usually gathered for the structuring of the scheme, all matters concerning the internal approval of such a scheme by the originator in terms of the Companies Act will form part of this duty. The company secretary of the originator must therefore ensure that all requirements regarding resolutions by the board of

<sup>220</sup> Section 234 (4).

<sup>221</sup> Section 236.

<sup>222</sup> See Cilliers *et al Corporate Law* at 156–157; Meskin *et al Henochsberg* at 447–448; Blackman *et al Commentary* at pars 8-327 to 8-328 and 8-330.

<sup>223</sup> The disclosure requirements for directors' conflicting interests are set out in cl 75 of the Companies Bill 61 of 2008. They do not materially differ from the process discussed here.

<sup>224</sup> Section 240(1).

<sup>225</sup> Section 241.

<sup>226</sup> Section 268A. See also Cilliers *et al Corporate Law* at 167–169; Meskin *et al Henochsberg* at 516; Blackman *et al Commentary* at par 9A-1.

<sup>227</sup> Section 268G(b).

directors, approval of the general meeting, if applicable, and disclosures of the securitisation in the financial statements of the company have been adhered to.

#### 6.5.1.5 Auditor

Section 275A(1) and (2), as inserted by the Corporate Laws Amendment Act 24 of 2006, prohibits the auditor of a widely-held company<sup>228</sup> to provide that company with non-audit services as specified in the Regulatory Board for Auditors' Code for Professional Conduct. This must be kept in mind if the same auditing firm is approached to provide advisory services during the structuring phase of a securitisation scheme.

In terms of section 300A(2), as inserted by the Corporate Laws Amendment Act 24 of 2006, the auditor must attend every annual general meeting of a widely-held company where the financial statements of the company will be considered and agreed to, so that he may respond to questions relating to the audit of the financial statements.<sup>229</sup> After the implementation of a securitisation scheme, the auditor must be prepared also to respond to questions regarding the effect of the securitisation on the financial statements of the originator, since this would fall under the audit.

### 6.5.2 Provisions of Companies Act 61 of 1973 important for SPV

The memorandum and articles of association of the SPV must limit the capacity and powers of the SPV so that the SPV may only engage in activities related to the securitisation scheme. The following considerations flowing from the Companies Act are also important for the SPV.

#### 6.5.2.1 Disclosure requirements

Any offers for subscription for shares in a company to the public must be accompanied by a prospectus that complies with the requirements of the Act.<sup>230</sup> The prospectus must be registered in the Companies Registration Office. Any director or

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<sup>228</sup> 'Widely-held company' is defined in s 1(6) of the Act. Basically all public companies and subsidiaries of public companies are widely-held companies. The term probably comes from the initial proposal in the Draft Companies Bill, 2007. The Draft Bill distinguished between widely-held and closely-held companies.

<sup>229</sup> The Companies Bill 61 of 2008 makes no mention of such a duty. See cl 93.

<sup>230</sup> Section 145(1). 'Offer to the public' is defined in s 142 as "any offer to the public and include an offer of shares to any section of the public, whether selected as members or debenture-holders of the company concerned or as clients of the person issuing the prospectus concerned or in any manner."



officer of a company who knowingly contravenes this provision is guilty of an offence.<sup>231</sup> ‘Share’ for the purposes of an offer of shares includes a debenture,<sup>232</sup> as well as any form of commercial paper issued by the SPV.<sup>233</sup>

However, there are instances when a prospectus is not required,<sup>234</sup> some of which could be applicable to the issue of commercial paper by the SPV. In these instances the offers are not regarded as offers to the public in terms of the Act.

A prospectus is not required if an offer for subscription is made to typical institutional investors, as listed in the Act.<sup>235</sup> Should the SPV decide to issue the securities through private placement to entities listed in the Act, a prospectus will not be necessary. A restriction in the offer for the securities to persons, so that each person must subscribe to securities to the value of R100 000 or more, will also render a prospectus unnecessary.<sup>236</sup> The offer must be made to the offeree as principal and not as an agent on behalf of the public. The idea behind this exclusion is that large sophisticated investors do not need the protection afforded by a prospectus.<sup>237</sup>

Barring the availability of one of these exceptions, a prospectus will have to accompany the offer for subscription in the commercial paper or other securities issued by the SPV. The matters that must be disclosed in a prospectus are set out in Part I and II of Schedule 3 of the Act.<sup>238</sup> Furthermore, the disclosure requirements of Securitisation Notice, 2008 must also be included in the prospectus.<sup>239</sup>

<sup>231</sup> Section 145(2).

<sup>232</sup> Section 1(1): “‘Share’ in relation to an offer of shares for subscription or sale, includes a share and a debenture of a company, whether a company within the meaning of this Act or not, and any rights or interests (by whatever name called) in a company or in any such share or debenture.”

<sup>233</sup> For a detailed discussion of the disclosure requirements in the Companies Act 61 of 1973, see Cilliers *et al Corporate law* at 255 *et seq*; Blackman *et al Commentary* at par 6-1 *et seq*.

<sup>234</sup> See s 144.

<sup>235</sup> Section 144(a) lists these as a registered bank, a registered mutual bank and a registered insurer, as well as a wholly owned subsidiary of such a registered bank, registered mutual bank or registered insurer when it acts as agent in the capacity of authorised portfolio manager for a registered pension fund or when it acts as a registered management company for a unit trust scheme.

<sup>236</sup> Section 144(b). See also Meskin *et al Henochsberg* at 265. Clause 93 the Companies Bill 61 of 2008 leaves these provisions unchanged.

<sup>237</sup> See also Blackman *et al Commentary* at par 6-11 to 6-13.

<sup>238</sup> Section 148, as amended by the Corporate Laws Amendment Act 24 of 2006.

<sup>239</sup> See par 6.2.5.

### 6.5.2.2 Auditor

The appointment of the auditor of a company is regulated by Chapter X of the Act.<sup>240</sup> The auditor of a company must report to its members on the matters prescribed in the Act and carry out all duties imposed on him by the Act or by the law.<sup>241</sup> The certification by the auditor that the SPV has complied with the requirements of Securitisation Notice, 2008 will be one of the duties imposed on him by another statute.<sup>242</sup>

## 6.6 COMPANIES BILL 61 OF 2008

The Department of Trade and Industry published the Draft Companies Bill on 5 February 2007 for public comment. The Companies Bill was published in June 2008.<sup>243</sup> The new Companies Act is scheduled to be implemented on 1 January 2010. Cognisant of the fact that my discussion falls in a transitional phase between the old and the new Companies Act, I shall discuss amendments brought about by the proposed legislation that will influence the structure and implementation of a securitisation scheme.

### 6.6.1 Memorandum of Incorporation

At present a company is incorporated with two constitutive documents, namely (1) the memorandum of association and (2) the articles of association. The memorandum of association is the founding document of a company and forms the basis for its whole corporate structure.<sup>244</sup> The requirements for the memorandum of association of a company are currently set out in section 52 of the Companies Act. It must contain, among other things, the purpose for which the company is formed, describing the

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<sup>240</sup> Sections 269–283. Chapter 3 of the Companies Bill 61 of 2008 deals with the appointment and functions of the auditors of companies.

<sup>241</sup> Section 282. Section 300 sets out the auditor's duties with regard to the annual financial statements and other matters. Section 301 sets out the requirement of the auditor's report that the annual financial statements fairly represent the state of affairs of the company and its operations.

<sup>242</sup> See par 6.2.5.

<sup>243</sup> In 2004 the Department of Trade and Industry published a policy paper entitled *Company Law for the 21st Century*. Some of the objectives of the policy paper were to modernise the Companies Act and to launch an overall review of company law. During the following two years the Department consulted widely, which led to the following five goal statements for the new Act: simplification, flexibility, corporate efficiency, transparency and predictable regulation. The Companies Bill aims to give effect to these goals. See the Explanatory Memorandum to the Draft Companies Bill, 2007.

<sup>244</sup> Cilliers *et al Corporate Law* at 67.

main object of the company and the general nature of the main business of the company. It must further state the share capital of the company and the number of shares that each subscriber will take up. The memorandum may also contain special conditions and may set requirements additional to those prescribed in the Act for the alteration of the memorandum.<sup>245</sup>

As discussed above, the memorandum of association of an SPV will limit its capacity to transactions concerned with the securitisation scheme and matters incidental thereto.<sup>246</sup> Such a limitation of the capacity of the SPV is also a requirement of Securitisation Notice, 2008<sup>247</sup> and is important for rating agencies when they consider the rating of the securities issued by the SPV.<sup>248</sup>

The articles of association play a subordinate role to the memorandum and are mainly concerned with the internal management and administration of the company. Matters that are typically governed by the articles are the rights, powers and duties of the members and the directors.<sup>249</sup> The Companies Act does not prescribe what the contents of the articles must be and so they may be drafted according to the needs of the company, as long as they are not in conflict with the general law or with provisions of the Companies Act.<sup>250</sup>

The articles of association of an SPV will typically deny powers to its directors to engage in any transaction not concerned with the securitisation scheme.<sup>251</sup>

The Companies Bill 61 of 2008 introduces one constitutive document for the incorporation of a company, namely a memorandum of incorporation.<sup>252</sup> However, the memorandum of incorporation may permit the board of directors to publish rules for the governance of the company.<sup>253</sup> These rules must also be filed with the Registrar of

<sup>245</sup> Section 53(a) of the Companies Act 61 of 1973.

<sup>246</sup> See par 2.3.3.

<sup>247</sup> See par 6.2.5.

<sup>248</sup> See par 2.6.1.

<sup>249</sup> Cilliers *et al Corporate Law* at 67. On the memorandum and articles of association of a company generally, see Blackman *et al Commentary* at pars 4-88 to 4-104.

<sup>250</sup> Cilliers *et al Corporate Law* at 75. The Act contains model sets of articles in Table A of Schedule 1 (public company having a share capital) and in Table B of Schedule 1 (private company having a share capital), but these may be adapted.

<sup>251</sup> See par 2.3.3.

<sup>252</sup> Clause 15.

<sup>253</sup> Clause 15(3).

Companies.<sup>254</sup> Any rule that is inconsistent with the Act or with the memorandum of incorporation will be void to the extent of the inconsistency.<sup>255</sup> In effect, such a company will still be governed by two documents, namely a founding document in the form of the memorandum of incorporation and the rules drawn up by the board of directors.

A notice of incorporation, together with a copy of the memorandum of incorporation, must be filed with the Registrar.<sup>256</sup> However, the filing of the memorandum of incorporation becomes less important, because the Bill diminishes the role of the doctrine of constructive notice and the *ultra vires* doctrine. This is discussed below.

### **6.6.2 *Ultra vires* doctrine and doctrine of constructive notice**

The Draft Companies Bill, 2007 provided that a company would have the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such powers, or having such capacity.<sup>257</sup> This would have abolished the *ultra vires* doctrine with regard to companies regulated by the Act.<sup>258</sup> The Companies Bill 61 of 2008 does not go quite as far, but provides specifically that the capacity of a company may be limited in its memorandum of incorporation.<sup>259</sup>

The main objects of a company are currently set out in its memorandum of association. Since the memorandum of association and the articles of association of a company are filed with the Registrar of Companies and are open for public inspection, third parties are deemed to be fully aware of their contents.<sup>260</sup> Consequently, third parties cannot assert that they were unaware that a company acted outside its capacity, or that they were unaware of an express limitation on the authority of the directors of the company. This is referred to as the doctrine of constructive notice.

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<sup>254</sup> Clause 15(3)(b).

<sup>255</sup> Clause 15(4)(a).

<sup>256</sup> Clause 13(2).

<sup>257</sup> Clause 12(1)(b).

<sup>258</sup> See below.

<sup>259</sup> Clause 19(1)(b) reads as follows: "From the date and time that the incorporation of a company is registered, as stated in its registration certificate, the company has all of the legal powers and capacity of an individual, except to the extent that (i) a juristic person is incapable of exercising any such power, or having any such capacity; or (ii) the company's Memorandum of Incorporation provides otherwise."

<sup>260</sup> Cilliers *et al Corporate Law* at 181.

However, the Bill provides that a person is not deemed to have notice or knowledge of the contents of any document relating to a company merely because the document has been filed or is accessible for inspection at an office of the company.<sup>261</sup> This limits the doctrine of constructive notice in regard to companies. However, the doctrine is not totally abolished, because clause 19(5)(a) provides that if the notice of incorporation drew attention to a specific provision of the memorandum of incorporation that is applicable to that company, or that may not be amended,<sup>262</sup> a person must be regarded as having received notice of such a provision.

The *ultra vires* doctrine was developed by analogy of a company created by a special Act of Parliament.<sup>263</sup> Such a company only exists for the purpose for which it is brought into existence by that Act and only has the powers to perform acts related to that purpose. So too, companies created by general enabling legislation, such as the Companies Act, must exist only for the purpose stated in its memorandum of association and only have the powers to act in matters concerning that purpose. The memorandum and articles further constitute a contract between the company and its members and between the members *inter se*, so that a member could compel a company to stay within its stated objects.<sup>264</sup>

In terms of the common law, transactions *ultra vires* the company were void and each party was obliged to restore to the other anything he received in the course of such a transaction.<sup>265</sup> The general meeting could not ratify such an 'act'.

The effects of the *ultra vires* doctrine have already been curtailed considerably by the Companies Act. Section 36 provides that no act of a company shall be void by reason only of the fact that the company did not have the capacity to enter into the

<sup>261</sup> Clause 19(4). The Office of the Commissioner will replace the current Registrar of Companies. See cl 189 for the provisions on the appointment of the Commissioner.

<sup>262</sup> In terms of cl 15(2)(b) and (c).

<sup>263</sup> Cilliers *et al Corporate Law* at 181. The purpose of the doctrine was twofold. First, it aimed to protect investors in the company so that the money they invested could only be employed for the objects stated in the memorandum. Second, it aimed to protect the company's creditors by ensuring that the company's funds, to which they look for payment, were not used for unauthorised activities. See Blackman *et al Commentary* at par 4-17 to 4-18. However, in practice the doctrine did not have the desired effect. An *ultra vires* transaction was void, even when the third party acted in good faith. Also, it became practice to include so many ancillary and future objects in the memorandum that the document did not provide a clear indication of the scope of the objects of the company. See Blackman *et al Commentary* at par 4-19.

<sup>264</sup> See also s 65(2) of the Companies Act 61 of 1973.

<sup>265</sup> Cilliers *et al Corporate Law* at 182.

transaction or because the directors did not have the authority to enter into the transaction based on a lack of capacity by the company.<sup>266</sup>

I submit that the Companies Bill leaves enough flexibility for the inclusion of restrictions in the memorandum of incorporation of an SPV to limit its capacity and the powers of its directors to act outside such capacity.

The memorandum of incorporation of a company and its rules, if adopted, will still be binding between the company and its shareholders and between the shareholders *inter se*.<sup>267</sup> The Bill retains a provision that an act of a company will not be void solely because the company did not have the capacity to act, or because the directors did not have the authority to act solely because the company itself did not have the capacity or power to act.<sup>268</sup>

The shareholders and directors of the company must guard against contravention of a limitation of the capacity of the company. Shareholders or directors of the company may take proceedings to restrain the company or the directors from doing anything inconsistent with any limitation, restriction or qualification contained in the memorandum of incorporation.<sup>269</sup> Such proceedings will be without prejudice to the rights to damages by a third party who obtained those rights in good faith and who did not have actual knowledge of the limitation in the powers and capacity of the company.<sup>270</sup>

Clause 20(2) gives shareholders the power to ratify an action by a company that is inconsistent with a limitation, restriction or qualification in the purposes, powers or activities of the company. Such ratification must be in the form of a special resolution,<sup>271</sup> and the action may not be in contravention of another provision of the Bill.<sup>272</sup>

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<sup>266</sup> For a discussion of s 36, see Cilliers *et al Corporate Law* at 182–188; Meskin *et al Henochsberg* at 64–68; Blackman *et al Commentary* at par 4-22 to 4-51.

<sup>267</sup> Clause 15(6).

<sup>268</sup> Clause 20(1)(a), which is similar to the current s 36 of the Companies Act 61 of 1973.

<sup>269</sup> Clause 20(5).

<sup>270</sup> Clause 20(5)(a) and (b).

<sup>271</sup> Clause 65(9) provides that the holders of at least 75 per cent of the shares that were voted on the resolution must be in favour in order to pass a special resolution. This number may be lessened to a minimum of 60 per cent in the memorandum of incorporation.

<sup>272</sup> Clause 20(3).

Market forces will also urge shareholders and directors of an SPV to uphold the limitations on the powers and capacity of an SPV. Rating of the securities issued by the SPV will continue throughout the existence of the scheme.<sup>273</sup> A contravention of the terms of the memorandum of incorporation will reflect negatively on the insolvency insulation of the SPV and may lead to a downgrade in the rating.<sup>274</sup>

Ratification by shareholders of a breach of the limitation on the powers and capacity of the SPV will further be a contravention of paragraph 2(1)(c) of the Schedule to Securitisation Notice, 2008, which provides that the SPV may not engage in any other activity than those associated with the securitisation scheme. The provision for non-compliance with the Notice will then take effect.<sup>275</sup>

### 6.6.3 Separation of Powers

The articles of association of a company may currently provide that the management of a company will vest with the board of directors and the shareholders will not be able to interfere with this function.<sup>276</sup> The Companies Bill makes this situation applicable to all companies, unless specifically limited in the memorandum of incorporation of the company, or in the Bill.<sup>277</sup> The decision to engage in a securitisation scheme will therefore fall under the authority of the board of directors of the originator, unless such authority is limited in the memorandum of incorporation.

### 6.6.4 Affected Transactions

The definition of an ‘affected transaction’ in the Bill includes a transaction or series of transactions amounting to the disposal of all or the greater part of the assets or undertaking of a regulated company.<sup>278</sup> The Takeover Regulation Panel will have to regulate and approve such a transaction,<sup>279</sup> unless the Panel has granted an exemption

<sup>273</sup> See par 2.6.

<sup>274</sup> See par 2.3.3.

<sup>275</sup> See pars 6.2.5 and 6.3.

<sup>276</sup> See the discussion under par 6.5.1.

<sup>277</sup> Clause 66(1).

<sup>278</sup> Clause 117(1)(c).

<sup>279</sup> Clause 119(1).

from approval of that transaction.<sup>280</sup> The Panel may exempt a person from the Takeover Regulations if there is no reasonable potential for the affected transaction to prejudice the interests of any existing shareholder, or if the cost of compliance is disproportionate to the value of the affected transaction, or if doing so is otherwise reasonable and justifiable in the circumstances.<sup>281</sup>

As in the current Act,<sup>282</sup> a special resolution is required for the disposal of all or the greater part of the assets or undertaking of a company.<sup>283</sup> However, a court must sanction the resolution if the holders of at least 15 per cent of the shares that were voted on the resolution voted against its adoption and any shareholder who voted against the resolution seeks a review of the transaction from the company.<sup>284</sup> The company must then seek court approval or treat the resolution as a nullity.<sup>285</sup> The court will grant such leave only if it is satisfied that the applicant is acting in good faith, appears prepared to sustain proceedings and has alleged facts which, if true, would support the setting aside of the resolution.<sup>286</sup> The court will set aside the resolution if it is satisfied that the resolution is manifestly unfair to any class of shareholders, or that the vote was materially tainted by a conflict of interest, inadequate disclosure, or a failure to comply with the Act,<sup>287</sup> with the memorandum of incorporation or any applicable rules of the company, or if there was another significant and material irregularity.<sup>288</sup>

A shareholder who is not in favour of the resolution may give the company notice in writing of his objection.<sup>289</sup> If the resolution was carried and the shareholder voted his shares against the adoption of the resolution, the company must purchase such a shareholder's shares at a fair market value when called upon by the shareholder to do so.<sup>290</sup>

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<sup>280</sup> Clause 119(6).

<sup>281</sup> Clause 119(6)(a)–(c).

<sup>282</sup> See par 6.5.1.1.

<sup>283</sup> Clause 115(2).

<sup>284</sup> Clause 115(3).

<sup>285</sup> Clause 115(5).

<sup>286</sup> Clause 115(6).

<sup>287</sup> Referring to the provisions of the Companies Bill 61 of 2008.

<sup>288</sup> Clause 115(7).

<sup>289</sup> See cl 115(8) and 164(3).

<sup>290</sup> Clause 164(5).



These provisions effectively leave the protection of minority shareholders, where a disposal of the assets or undertaking of a company is proposed, to the court. It remains unclear why these provisions are included in the sphere of the Securities Regulations.<sup>291</sup>

That part of the undertaking or assets of the company that is to be disposed of must be assigned its fair market value as at the date of the proposal of the resolution. It will depend on the circumstances whether a proposed securitisation scheme will constitute the disposal of substantially all of the assets of the company. If a particular securitisation transaction constitutes such a disposal, the protection of shareholders in these circumstances is, in my opinion, warranted. However, I submit that the comments of Luiz,<sup>292</sup> namely that the protection of minority shareholders under these circumstances ought not to be regulated by the provisions relating to take-overs and mergers, still apply. The same result could be achieved by not placing such transactions under the auspices of the Panel, but only to require the court's sanction.

## 6.7 SECURITIES SERVICES ACT 36 OF 2004

The Securities Services Act 36 of 2004 provides for the regulation and control of securities exchanges and securities trading, central securities depositories and the custody and administration of securities, the prohibition of insider trading and the licensing of clearing houses. This Act is applicable to a securitisation scheme when the SPV wants to trade its securities on a securities exchange and if it uses a central securities depository in the administration of uncertificated securities.

The Act obliges exchanges to issue listing requirements to regulate the requirements that issuers must comply with in order to list their securities on that exchange.<sup>293</sup> The exchange must further issue rules that must at least contain rules on the matters listed in section 18 of the Act. The matters listed in section 18 mostly relate to the regulation of authorised users of the exchange, in other words, stockbrokers. However, the rules usually also include provisions on the listing, trading

<sup>291</sup> See the discussion in par 6.5.1.2. The Bill does not contain a definition of 'offeree company', but defines 'regulated companies' in cl 118.

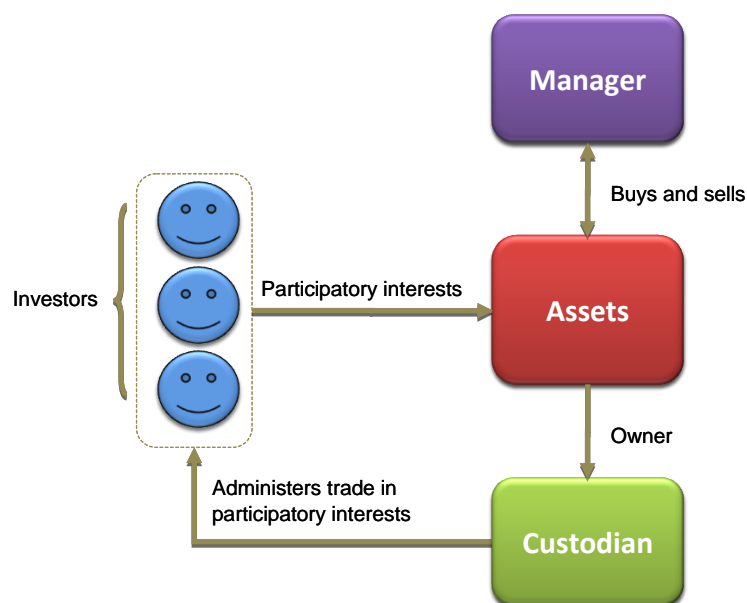
<sup>292</sup> 2004 *SA Merc LJ* at 14 and 16. See also the discussion in par 6.5.1.2.

<sup>293</sup> Section 12.

and settlement of securities listed on the exchange.<sup>294</sup> These listing requirements and the rules of the securities exchange where the SPV intends to list its securities must also be kept in mind during the structuring of the securitisation scheme.

## 6.8 COLLECTIVE INVESTMENT SCHEMES CONTROL ACT 45 OF 2002

The Collective Investment Schemes Control Act 45 of 2002 regulates and controls the establishment and administration of collective investment schemes. In a typical collective investment scheme investors contribute money in exchange for participatory interests in the scheme. The money is used by the manager of the scheme to buy and sell assets in order to maximise profits. These assets are often securities or immovable property. The custodian of the scheme administers the trade in the participatory interests, for instance by recording ownership of the participatory interests and keeping track of payments made to investors.<sup>295</sup>



**Figure 7: Simplified collective investment scheme**

<sup>294</sup> The rules of the Bond Exchange of South Africa are available at [www.bondexchange.co.za](http://www.bondexchange.co.za) (accessed 12 October 2007).

<sup>295</sup> See s 70 for the duties of the custodian.

Scott<sup>296</sup> is of the opinion that a securitisation scheme may qualify as a collective investment scheme and that this Act therefore applies. I agree with this view, as will become clear from the discussion that follows.

Schemes that fall under the ambit of the Act fall under the supervision of the Financial Services Board.<sup>297</sup> The executive officer and deputy executive officer of the Financial Services Board are the Registrar and Deputy Registrar of collective investment schemes respectively. According to the Financial Services Board a securitisation does not qualify as a collective investment scheme.<sup>298</sup> In their opinion the only relevance that securitisation may have in connection with a collective investment scheme is that, depending on the structure of the securities created by the SPV, such securities may qualify as an investment that may be included in the portfolio of a collective investment scheme.<sup>299</sup>

In my opinion, it is clear from a reading of the Act and its regulations that they were not meant for application to securitisation schemes. The structures created by the Act are aimed at safeguarding the interests of investors where the managers of the scheme buys *and sells* securities or property on a regular basis. Whereas the SPV issues securities to fund the acquisition of assets from the originator, the manager of a collective investment scheme needs capital of its own in order to initiate the scheme.<sup>300</sup> The minimum capital requirements of the managers of collective investment schemes are prescribed.<sup>301</sup>

The custodian of the scheme must maintain capital and reserves of not less than R10 million.<sup>302</sup> The duties of the custodian differ from those of a trustee for investors during securitisation. The custodian is directly responsible for the administration of

<sup>296</sup> 2006 SA *Merc LJ* at 405–406. References in this par to ‘the Act’ refer to the Collective Investment Schemes Control Act 45 of 2002.

<sup>297</sup> Section 7.

<sup>298</sup> My thanks to Stiaan Hyman from the Financial Services Board for providing me with their position. The document is on file with me.

<sup>299</sup> GN 1503 in *GG* 28287 (15 December 2005), in terms of ss 40, 46 and 85 of the Collective Investment Schemes Control Act 45 of 2002.

<sup>300</sup> Also referred to as ‘seed capital’.

<sup>301</sup> GN 578 in *GG* 24984 (28 February 2003); GN 2075 in *GG* 25283 (1 August 2003); GN 575 in *GG* 24984 (28 February 2003); GN 2074 in *GG* 25283 (1 August 2003); GN 572 in *GG* 24984 (28 February 2003); GN 2072 in *GG* 25283 (1 August 2003).

<sup>302</sup> Section 69(2)(a).

the trade in participatory interests in the collective investment scheme.<sup>303</sup> The custodian is obliged to follow the instructions of the manager, unless they are inconsistent with the provisions of the Act or with the deed.<sup>304</sup> It follows that the custodian does not truly function independently from the manager, although it has certain supervisory functions with regard to the manager.<sup>305</sup>

Most importantly, the custodian does not hold the assets as security for the participations of the investors. Rather, it appears to me that the custodian becomes the owner of the assets and that the rights of the investors are those of beneficiaries in a trust.<sup>306</sup> The custodian indemnifies both the manager and the investors against any loss or damage to money or assets in its custody caused by the custodian's wilful or negligent act or omission.<sup>307</sup> This explains the high capital maintenance requirements set for custodians.

However, neither the denial by the Financial Services Board that the Act is applicable, nor the differences in structure between securitisation schemes and the structures provided for in the Act as set out above necessarily mean that a securitisation scheme cannot be construed as a collective investment scheme.

Securitisation schemes are not specifically excluded from the operation of the Act. The definition of 'collective investment scheme' provided in the Act is so wide that it could include a securitisation scheme. It reads as follows:<sup>308</sup>

[A] scheme, *in whatever form*, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which –

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<sup>303</sup> Sections 70(1)(a) and (b).

<sup>304</sup> Section 70(1)(c). 'Deed' here refers to the agreement between the manager and the custodian, or the document of incorporation of the collective investment scheme, by which the scheme was established and in terms of which it is administered (s 1).

<sup>305</sup> See ss 70(1)(f)–(g) and ss 70(2)–(4).

<sup>306</sup> Section 71. The Financial Institutions (Protection of Funds) Act 28 of 2001 applies to the custodian and manager in their dealings with the money received from investors and the assets acquired with that money. Section 4(5) of the Financial Institutions (Protection of Funds) Act 28 of 2001 provides that trust property kept by such institutions will under no circumstances form part of the assets or funds of the institution. The Act further contains provisions that set out the duties of the institutions that keep funds or trust property on behalf of others in terms of the Act (s 2), declarations by officials of the institution when they have interests in the undertaking in which the institution wants to invest (s 3) and provisions regarding the investment of the trust property (s 4). The Act falls under the supervision of the FSB (s 6). Only the Financial Institutions (Protection of Funds) Act 28 of 2001 applies to collective investment schemes. The Trust Property Control Act 57 of 1988 is not applicable (s 113 of the Collective Investment Schemes Control Act 45 of 2002).

<sup>307</sup> Section 72.

<sup>308</sup> Section 1.

- (a) two or more investors contribute money or other assets to hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and
- (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment scheme authorised by any other Act (my emphasis).<sup>309</sup>

A securitisation scheme where the SPV issues securities by way of private placements will not fall under this definition, because it would not be an invitation made to the general public.

The trustee for debenture-holders is discussed in Chapter 6.<sup>310</sup> There I concluded that the agency construction for the debenture trust is not workable or in the best interests of the investors. The trust construction is preferable. I further showed that a debenture trust could be a true trust, as long as the investors transfer their claims to the trustee.

I mentioned above that the custodian in a collective investment scheme is in the position of a trustee and the owner of the assets held in custody. For a securitisation scheme to be construed as a collective investment scheme, there must be a true trust in the sense that the trustee (or custodian) must become the owner, or the legal holder, of the assets of the SPV and of the money contributed by the investors. This will be the case if the true trust construction of the debenture trust is used in the scheme, coupled with a fiduciary security cession of the assets of the SPV. The investors will then be beneficiaries under a trust arrangement, with a participatory interest in the income generated by the assets. This, in my opinion, could fall under the definition of a collective investment scheme.<sup>311</sup>

In the United States of America and in England the possible application to securitisation schemes of the regulatory framework for collective investment schemes

<sup>309</sup> In terms of s 1 ‘portfolio’ means: “a group of assets including any amount of cash in which members of the public are invited or permitted by a manager to acquire, pursuant to a collective investment scheme, a participatory interest or a participatory interest of a specific class which as a result of its specific characteristics differs from another class of participatory interests.” This definition is wide enough to include the assets of the SPV. ‘Assets’ are also defined in such a manner that it might include the assets acquired by the SPV. ‘Assets’ for purposes of the Act means: “the investments comprising or constituting a portfolio of a collective investment scheme and includes any income accruals derived or resulting from the investments in the portfolio which are held or are due to the investors in that portfolio.”

<sup>310</sup> Paragraph 2.8.2.2 *et seq.*

<sup>311</sup> According to Wood *Project Finance* at 122, the SPV as a company is less likely to be considered a collective investment scheme than when the SPV is a trust. Under the true trust construction of a trust for debenture-holders the trust could be considered a second SPV that acts on behalf of the debenture-holders.

is acknowledged.<sup>312</sup> Compliance with these regulations is costly and time consuming. Consequently, SPVs, and in some cases also the originators, usually apply for exemption from compliance with these provisions. Alternatively, they structure the scheme in such a manner that it will fall under one of the exemptions of the applicable legislation and therefore will not be construed as a collective investment scheme.

It is in the best interest of the securitisation scheme and of the investors in the scheme to have certainty about the applicability of the Collective Investment Schemes Control Act. In my opinion, the best solution would be for the Registrar of Collective Investment Schemes to issue an exemption by way of notice to exclude securitisation schemes from the ambit of the Act.<sup>313</sup> For the time being, section 22 provides that the Registrar may exempt a particular manager or a category of persons from any provisions of the Act on such conditions and to such an extent as he may determine. SPV's could apply for such an exemption. This might be time-consuming, but at least there will be certainty about whether the restrictions contained in the Act are applicable to the scheme. There will also be certainty about whether the Trust Property Control Act<sup>314</sup> is applicable to the scheme, because if the scheme is found to be a collective investment scheme the application of that Act is specifically excluded.<sup>315</sup>

## 6.9 DEBT COLLECTORS ACT 114 OF 1998

The Debt Collectors Act 114 of 1998 establishes the Council for Debt Collectors, which has the object to exercise control over the occupation of debt collector.<sup>316</sup> A 'debt collector' is defined in section 1 of the Act as:

- (a) a person, other than an attorney or his or her employee or a party to a factoring arrangement, who for reward collects debts owed to another on the latter's behalf;
- (b) a person who, other than a party to a factoring arrangement, in the course of his or her regular business, for reward takes over the debt referred to in paragraph (a) in order to collect them for his or her own benefit;

<sup>312</sup> See pars 3.3.1.1 and 4.3.1.1.

<sup>313</sup> In terms of s 5(b) of the Collective Investment Schemes Control Act 45 of 2002. See par 4.3.1.1 for the provisions of the exemption in the USA (Investment Company Act, Rule 3a-7). Similar provisions could lead to greater certainty in South Africa.

<sup>314</sup> 57 of 1988.

<sup>315</sup> Section 113 of the Collective Investment Schemes Control Act 45 of 2002.

<sup>316</sup> Section 2(2). The Council maintains a website where all relevant legislation as well as the Code of Conduct for Debt Collectors may be accessed. See [www.debtcol-council.co.za](http://www.debtcol-council.co.za) (accessed 25 July 2008).

- (c) a person who, as an agent or employee of a person referred to in paragraph (a) or (b) or as an agent of an attorney, collects the debts on behalf of such a person or attorney, excluding an employee whose duties are purely administrative, clerical or otherwise subservient to the actual occupation of debt collector.

Factoring arrangements are excluded from the definition of ‘debt collector’, but this is so far the only exclusion. The Regulations relating to Debt Collectors, 2003<sup>317</sup> do not exclude any other class of debt collector, although the Act does make provision for such exclusion, if necessary.<sup>318</sup> It follows that the servicer of the claims during a securitisation scheme will resort under the definition of ‘debt collector’ in terms of the Act and will need to register as such.<sup>319</sup>

The Act disqualifies persons who have been convicted of offences involving violence, dishonesty, extortion or intimidation from registration as a debt collector.<sup>320</sup> Other disqualifications relate to previous improper conduct in terms of section 15 of the Act, if the person is of unsound mind, minors and unrehabilitated insolvents. The directors and officers, or members in the case of close corporations, of juristic persons who register as debt collectors must also qualify and be registered in terms of the Act. There is a small registration and annual fee payable to the Council.<sup>321</sup> None of these requirements is onerous and I submit that servicers will easily comply with them.

The main task of the Council is to draw up and publish in the *Government Gazette* a code of conduct for debt collectors, which is binding on all debt collectors in terms of the Act.<sup>322</sup> The Code of Conduct was published on 16 May 2003.<sup>323</sup> Apart from the Code, section 15 of the Act sets out further conduct by debt collectors that will be considered improper. In essence all of these provisions entail that debt collectors must

<sup>317</sup> GN R185, GG 24351 (7 February 2003).

<sup>318</sup> Section 26.

<sup>319</sup> Section 8(1). Henk Delpont “Of Rent Collectors and Debt Collectors” (2004) 25 *Obiter* at 159 argues that the term ‘debt collector’ as used in the Act implies more than the sending out of invoices or reminders that payment is due. Simply receiving the amounts payable is according to him also not what is meant by the term. In his opinion ‘collect’ is referred to here in the narrow sense, meaning to take steps “which are aimed at recovering payment from debtors by compelling or bringing pressure on them to pay amounts which otherwise they would not, or did not, pay.” I agree with Delpont’s view. However, the servicer during a securitisation transaction will still fall within this narrow interpretation of the definition. On the functions of servicers in general, see par 2.7.

<sup>320</sup> Section 10.

<sup>321</sup> Section 13. See also regulations 2(a) and 6(1) of the Regulations relating to Debt Collectors, 2003.

<sup>322</sup> Section 14.

<sup>323</sup> GN R663, GG 24867 (16 May 2003).

not conduct themselves in a manner that is tantamount to harassment, threats of violence and other specified intimidating behaviour.

Debt collectors are further restricted in the amounts that they recover from the debtor to the capital amount of the debt and interest due and payable, as well as necessary expenses and fees.<sup>324</sup>

In my opinion, the most important provisions of the Act for purposes of this discussion are contained in section 20. Section 20(1) provides that a debt collector must open and maintain a separate trust account at a bank into which money collected on behalf of any person must be deposited as soon as possible after receipt thereof. Such money must then be paid to the person on whose behalf it was collected within a reasonable or agreed time.<sup>325</sup> The section further requires the debt collector to keep proper accounting records of all money received, held or paid by him on behalf of another person<sup>326</sup> and the debt collector must account to that person at least once a month.<sup>327</sup> The accounting records must be audited,<sup>328</sup> as well as the trust account.<sup>329</sup>

Finally, and most importantly, section 20(7) of the Act provides that no amount standing to the credit of such a trust account shall form part of the assets of the debt collector and may not be attached by the creditors of the debt collector. I discuss the various forms that the agreement between the servicer and the SPV can take in chapter 7. Regardless of the form that the parties decide on, section 20(7) of the Act provides a measure of protection for the SPV and its investors. This is especially true where the parties decide that the claims will be ceded to the servicer for collecting purposes. Until such time as the claims are collected, the claims will form part of the estate of the servicer. However, the moment that the claims are collected and paid into the trust account, the money so collected will no longer form part of the estate of the servicer.<sup>330</sup>

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<sup>324</sup> Section 19(1). The expenses and fees that debt collectors are allowed to recover from the debtor are set out in Annexure B and Regulation 11 of the Regulations relating to Debt Collectors, 2003.

<sup>325</sup> Section 20(2).

<sup>326</sup> Sections 20(3)–(4).

<sup>327</sup> Section 20(2).

<sup>328</sup> Section 20(6).

<sup>329</sup> Regulation 10 of the Regulations relating to Debt Collectors, 2003.

<sup>330</sup> See par 7.3.3.



## 6.10 CONCLUSION

There is no consolidated statutory regulation of securitisation in South Africa. This may prove beneficial for innovation in securitisation, since consolidated legislation might not be able to foresee all aspects of such innovation and might be a bar to it. Another reason why consolidated legislation might not be necessary is that a securitisation scheme already contains various measures to reduce risk to investors and to monitor the servicing of the assets of the SPV. In other words, securitisation is self-regulatory.

The single most important regulation pertaining to securitisation in South Africa is Securitisation Notice, 2008.<sup>331</sup> Though only relevant where the SPV intends to issue securities to the general public, it provides important guidance to securitisation schemes in general. Since SPVs that comply with its provisions will not be subject to the more stringent regulation applicable to banks, Securitisation Notice, 2008 provides an indication of what the Legislature regards as best practice.

An SPV that does not comply with the provisions of Securitisation Notice, 2008 when it issues securities to the general public, will fall under the provisions of Chapter VIII of the Banks Act.<sup>332</sup> These provisions essentially aim to reverse the transactions that occurred while the transgressing institution was not registered as a bank. The Registrar of Banks can appoint a manager to oversee this process and extensive powers are given to the manager in this respect.

Both the SPV and the originator will be affected if such a manager is appointed. The SPV would have used the money raised from the issue of securities to pay for the transfer of the claims. The manager will have the authority to follow that money to the originator and to reclaim it in order to repay the investors. It is doubtful whether it will be possible to reverse a securitisation scheme without loss to the investors in the scheme. Furthermore, the originator will suffer severe reputational loss under these circumstances.

The Banks Amendment Act<sup>333</sup> amends Chapter VIII, dealing with the management of an institution that did not comply with the exemption notice.<sup>334</sup> In future the

<sup>331</sup> See par 6.2.5.

<sup>332</sup> 94 of 1990. See par 6.3.

<sup>333</sup> 20 of 2007.

<sup>334</sup> See par 6.3.1.

manager must report on the solvency of the scheme on his appointment. The Registrar is given extensive powers under the Act to prevent the onset of liquidation proceedings and to stay all legal action against the institution under management. When the institution is an SPV under a securitisation scheme, it will in my opinion be in the best interests of the investors in the scheme if the Registrar consults with the trustee for debenture-holders before taking action in terms of Chapter VIII. I recommend that a future amendment of Securitisation Notice should provide for such consultation to take place. I am also of the opinion that the trustee may be the proper person to appoint as manager when the provisions of Chapter VIII take effect.

I considered those provisions of the National Credit Act<sup>335</sup> that might be of importance to securitisation.<sup>336</sup> In my opinion, proper consumer protection measures will aid securitisation in the long run, because the default patterns of debtors may become more predictable. Better predictability of such default patterns will in turn enhance the efficiency of the structuring of the securitisation scheme. Rating agencies will take special note of the provisions of the Act when they rate the quality of the claims ceded to the SPV.

Certain provisions of the Companies Act<sup>337</sup> are of specific importance before and during a securitisation scheme.<sup>338</sup> It must be determined whether a particular securitisation will constitute the disposal of the whole or a substantial part of the assets or the undertaking of the originator.<sup>339</sup> If so, a special resolution by the members of the originator will be necessary to effect the scheme. The scheme will then also be an affected transaction that will fall under the supervision of the Securities Regulation Panel on Take-Overs and Mergers.<sup>340</sup> Conflicts of interest may arise where a director of the originator has interests in the SPV or in one of the other parties involved in the scheme.<sup>341</sup> The board of directors of the originator must be careful in this regard. Securitisation also places added duties on the shoulders of the

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<sup>335</sup> 34 of 2005.

<sup>336</sup> See par 6.4.

<sup>337</sup> 61 of 1973.

<sup>338</sup> See par 6.5.

<sup>339</sup> See par 6.5.1.1.

<sup>340</sup> See par 6.5.1.2.

<sup>341</sup> See par 6.5.1.3.

originator's company secretary, if appointed, and on the auditor of the originator and SPV. The SPV must issue a prospectus if its securities will be offered to the public.

I considered the provisions of the Companies Bill<sup>342</sup> that are, in my opinion, relevant to securitisation.<sup>343</sup> At present the memorandum of association of an SPV limits its capacity to transactions concerned with the securitisation scheme and matters incidental thereto.<sup>344</sup> Such a limitation of the capacity of the SPV is also a requirement of Securitisation Notice, 2008<sup>345</sup> and is important for rating agencies when they consider the rating of the securities issued by the SPV.<sup>346</sup> I concluded that the Companies Bill leaves enough flexibility for the inclusion of restrictions in the memorandum of incorporation of an SPV to limit its capacity and the powers of its directors to act outside such capacity. The potential for a downgraded rating and non-compliance with Securitisation Notice, 2008 will urge shareholders and directors of an SPV to uphold the limitations on the powers and capacity of an SPV.

The Bill still defines the disposal of the whole or a substantial part of the assets of a company as an affected transaction.<sup>347</sup> It further provides shareholder protection by requiring court sanction if more than 15 per cent of shareholders voted against the disposal and any shareholder who voted against the resolution applies for the court's review of the transaction. There is also a procedure in the Bill whereby a shareholder who was against the adoption of the resolution, may notify the company of his objection so that the company can purchase his shares at a fair market value. These provisions effectively leave the protection of minority shareholders, where a disposal of the assets or undertaking of a company is proposed, in the hands of the court. It remains unclear, as is the case under the current inclusion of section 228 transactions under the definition of an affected transaction, why these provisions are included in the sphere of the Securities Regulations.<sup>348</sup>

<sup>342</sup> 61 of 2008.

<sup>343</sup> See par 6.6.

<sup>344</sup> See par 2.3.3.

<sup>345</sup> See par 6.2.5.

<sup>346</sup> See par 2.6.1.

<sup>347</sup> See par 6.6.4.

<sup>348</sup> See the discussion in par 6.5.1.2.

The Securities Services Act<sup>349</sup> will be applicable to a securitisation scheme when the SPV wants to trade its securities on a securities exchange and if it uses a central securities depository in the administration of uncertificated securities.<sup>350</sup>

I considered whether a securitisation scheme could be construed to be a collective investment scheme within the meaning of the Collective Investment Schemes Control Act.<sup>351</sup> In my opinion, it is possible that a particular securitisation scheme could also fall within the definition of a collective investment scheme. I therefore recommend that the Registrar of Collective Investment Schemes creates certainty by specifically exempting securitisation schemes from the provisions of the Act. Until then it is advisable for SPV's to apply for exemption in terms of the Act.

Finally, I came to the conclusion that the servicer during a securitisation scheme will have to register as a debt collector in terms of the Debt Collectors Act.<sup>352</sup> Most importantly, the Act provides that amounts collected by a debt collector and deposited in the separate trust account it must maintain for such purposes, do not form part of his estate and cannot be attached by his creditors. This provides a measure of protection to the SPV and to its investors.

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<sup>349</sup> 36 of 2004.

<sup>350</sup> See par 6.7.

<sup>351</sup> 45 of 2002. See par 6.8.

<sup>352</sup> 114 of 1998. See par 6.9.

## CHAPTER 7

# TRANSFER OF CLAIMS AND 'TRUE SALE' REQUIREMENT

### 7.1 INTRODUCTION

It should be clear from the discussion so far that the transfer of the assets to the SPV should be done in such a manner that the assets will from a legal point of view, permanently be removed from the estate of the originator and vest in the estate of the SPV. The advantages associated with this form of financing are dependent on a 'true sale'. In this chapter I consider the form and requirements of the agreements between the originator and the SPV for these agreements to comply with the 'true sale' requirement. I also consider the nature of the agreement between the SPV and the servicer to the securitisation scheme, because in many cases the originator continues to act as the servicer. This may have implications when a court considers whether the original transaction was one of sale or of loan.

### 7.2 AGREEMENTS BETWEEN ORIGINATOR AND SPV

In this section I consider the nature of the agreement between the originator and the SPV.<sup>1</sup> At least two agreements must be distinguished between the originator and the SPV,<sup>2</sup> namely an obligatory agreement, in terms of which rights and obligations are created between the parties, and a transfer agreement,<sup>3</sup> by which the claims are transferred. However, the two agreements are not necessarily separated in time. The transfer agreement may be incorporated into the obligatory agreement.

For purposes of this section I assume that the sale of the claims by the originator to the SPV is not a simulated transaction<sup>4</sup> and that the true intention of the parties to the

<sup>1</sup> I do not discuss individual clauses of the agreement between the parties. In terms of Securitisation Notice, 2008 (GN 2, GG 30628 (1 January 2008) Notice on Banks Act 94 of 1990 – Designation of an Activity not Falling within the Meaning of 'The Business of a Bank' (Securitisation Schemes), Schedule, par 4(2)(o) ) certain clauses may not be included in the transfer agreement. I discuss these clauses in par 6.2.5.

<sup>2</sup> *Johnson v Incorporated General Insurance Ltd* 1983 (1) 318 (A) at 331G–H; *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 877G; *Botha v Fick* 1995 (2) SA 750 (A) at 762A–E; *Scott Cession* at 8 and 59. Other agreements might include the agreement to extinguish the obligation, and possibly a resolutive agreement, if the claims are receded to the originator when the claim needs to be collected judicially. See par 7.3.3. See also Scott 1979 *TSAR* at 48; Nienaber in Joubert *et al LAWSA* at 7–8.

<sup>3</sup> Scott 1979 *TSAR* at 51–52.

<sup>4</sup> See the discussion of simulated transactions in par 7.4.

contract is to enter into a contract of sale. A contract of sale is the obligatory agreement.<sup>5</sup>

### 7.2.1 Obligatory agreement: contract of sale

The terms of a contract may be classified as *essentialia*, *naturalia* or *incidentalia*.<sup>6</sup> *Essentialia* are those terms that are essential for the existence of a specific type of contract or for it to be classified as a contract of a specific type. *Naturalia* are terms that are not essential to the nature of a specific type of contract, but *ipso iure* flow from it. Such terms are included and understood to be part of that type of contract, unless specifically excluded through express agreement between the parties. *Incidentalia* do not flow from a specific type of contract *ipso iure*, but may be included by express agreement between the parties.

These concepts are especially important for the classification of contracts. The contract that gives rise to the obligation of the originator to transfer the claims to the SPV must take the form of a contract of sale. It is therefore important to ascertain what the *essentialia*, or essential elements, of a contract of sale are.

A contract of sale is a mutual agreement whereby one person, the seller, undertakes to deliver to another person, the purchaser, a thing and whereby the other person agrees to pay a sum of money in exchange.<sup>7</sup> The following are regarded as *essentialia* of a contract of sale:<sup>8</sup>

- There must be agreement on the thing to be sold.
- The agreement must determine a purchase price.<sup>9</sup>

The purchase price is given in return for undisturbed possession of the asset purchased. The intention must be to provide to the purchaser on a permanent basis all

<sup>5</sup> Although the term ‘obligatory agreement’ is the one usually employed by the Courts, I agree with Scott *Cession* at 59 that the term ‘obligatory agreement’ is preferable. It conveys the idea of an agreement that creates an obligation, which includes rights and duties.

<sup>6</sup> RH Christie & Victoria McFarlane *The Law of Contract in South Africa* 5 ed (2006) at 158–159; JC de Wet & AH van Wyk *Die Suid-Afrikaanse Kontraktereg en Handelsreg* 5 ed (1992) at 129.

<sup>7</sup> De Wet & Van Wyk *Kontraktereg* 5 ed at 313.

<sup>8</sup> De Wet & Van Wyk *Kontraktereg* 5 ed at 313; AJ Kerr *The Law of Sale and Lease* 3 ed (2004) at 3; AJ Kerr “Sale” in WA Joubert *et al The Law of South Africa Vol 24* (2000) at 3; Joubert *Kredietfaktorering* at 328–333.

<sup>9</sup> The price must be payable in money, otherwise it is not a sale contract. See De Wet & Van Wyk *Kontraktereg* 5 ed at 314; Kerr *Sale and Lease* at 29 *et seq.* As a general principal of contract law, the price must be certain or ascertainable.

the entitlements that are associated with the kind of asset sold. For historical reasons, South African law does not require transfer of ownership of a thing as an essential requirement for a contract of sale. It is a *naturalia* of a contract of sale that the seller will transfer ownership if he has it or can obtain it, failing which, to warrant against eviction.<sup>10</sup> However, Joubert<sup>11</sup> indicates that when the object of the sale is a claim, a term requiring the cession of the claim is an essential element of the contract.

The originator and the SPV will draft their obligatory agreement in the form of a contract of sale, making sure that it contains all the essential elements.

### 7.2.2 Transfer agreement

Typically, the obligatory agreement is the *justa causa* for the transfer agreement. The usual relationship between the transfer agreement and the obligatory agreement was stated as follows in *Johnson v Incorporated General Insurance Ltd*:<sup>12</sup>

Cession can be seen as an act of transfer to transfer a claim (*translatio juris*). This happens by means of a transfer agreement between the cedent and the cessionary derived from a *justa causa* from which the intention of the cedent to transfer the claim to the cessionary (*animus transferendi*) and the intention of the cessionary to become the legal holder of the claim (*animus acquirendi*) is shown or can be derived. The transfer agreement may coincide or be preceded by a *justa causa*, which could be an obligatory agreement such as a contract of sale, a barter, a donation, a settlement, or even a payment (*solutio*) (my translation).

The transfer of the claims from the originator to the SPV can either take the form of delegation or of cession. I submit that delegation is the agreement implied by Securitisation Notice, 2008:<sup>13</sup>

The transfer of the assets to or acquisition of assets by a special-purpose institution shall totally divest the transferring institution and all its associated companies and, when the transferring institution is a bank, divest any other institution within the banking group of which such a bank is a

<sup>10</sup> For a discussion of this issue, see Kerr *Sale and Lease* at 177 *et seq*; Kerr in Joubert *et al LAWSA* at 67 *et seq*; De Wet & Van Wyk *Kontraktereg 5 ed* at 329–332; Joubert *Kredietfaktorering* at 329–331.

<sup>11</sup> Joubert *Kredietfaktorering* at 331–333.

<sup>12</sup> 1983 (1) 318 (A) at 331G–H: “Sessie kan gesien word as ’n oordragshandeling (act of transfer) om die oordrag van ’n vorderingsreg (*translatio juris*) te laat plaasvind. Dit geskied deur middel van ’n oordragsooreenkoms (transfer agreement) tussen die sedent en die sessionaris uit hoofde van ’n *justa causa* waaruit die bedoeling van die sedent om die vorderingsreg op die sessionaris oor te dra (*animus transferendi*) en die bedoeling van die sessionaris om die reghebbende van die vorderingsreg te word (*animus acquirendi*), blyk of afgelei kan word. Die oordragsooreenkoms kan saamval met of voorafgegaan word deur ’n *justa causa* wat ’n verbintenisskeppende ooreenkoms (obligatory agreement) kan wees, soos bv ’n verkoopkontrak, ’n ruilkontrak, ’n skenkingskontrak, ’n skikkingsooreenkoms of selfs ’n betaling (*solutio*).” See also *Botha v Fick* 1995 (2) SA 750 (A) at 762B–D.

<sup>13</sup> Schedule, par 4(2)(a).

member, of all rights *and obligations*<sup>14</sup> originating from the underlying transactions and all risks in connection with the assets transferred or acquired (my emphasis).

However, I shall explore both delegation and cession, because for the reasons set out below I am of the opinion that, generally, cession lends itself much better to the objectives and structure of a traditional securitisation scheme.

#### 7.2.2.1 Delegation

Delegation is a form of novation whereby one party is completely substituted for another. As such, it requires the full co-operation and consent of the original debtor and creditor and the third party that will substitute one of the parties to the original agreement.<sup>15</sup>

Often legal documentation and even judgments use the term ‘assignment’ to refer to an agreement to transfer both rights and obligations.<sup>16</sup> Two recent Supreme Court of Appeal decisions used the term ‘assignment’ to denote a complete substitution of one party to an agreement for another party.<sup>17</sup> Christie<sup>18</sup> argues that what is meant by ‘assignment’ in these instances is really a delegation and that the use of the term ‘assignment’ by draftsmen has led to some confusion about the intention of the parties. Such confusion is aggravated by the fact that ‘assignment’ in English law refers to a transfer of rights only.<sup>19</sup> Here I shall use the term ‘delegation’.

Delegation differs from cession in that during delegation the previous claim is terminated and a new claim is created in its stead. During cession the claim is transferred and continues to exist unchanged. Since the original claim ceases to exist in a delegation, its accessory security rights will also be terminated. New security

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<sup>14</sup> The Notice makes use of the term ‘obligations’, but this is incorrect. An obligation is a legal bond between at least two persons where one, the debtor, is liable against the other, the creditor, to do something or not to do something. See De Wet & Van Wyk *Kontraktereg 5 ed* at 1; Christie & McFarlane *Law of Contract* at 5. From the perspective of the creditor the obligation is a right to claim performance. From the perspective of the debtor the obligation is a duty to perform. It is therefore more correct to refer to ‘claims’ and ‘duties’ and I shall use the term ‘duty’.

<sup>15</sup> Christie & McFarlane *Law of Contract* at 462; Nienaber in Joubert *et al LAWSA* at 11; De Wet & Van Wyk *Kontraktereg 5 ed* at 267–271.

<sup>16</sup> See *Talas Properties of Rhodesia (Pvt) Ltd v Abdullah* 1971 (4) SA 369 (R) at 373G; *Simon v Air Operations of Europe AB* 1999 (1) SA 217 (A) at 228I.

<sup>17</sup> *Telkom Ltd v Blom* 2005 (5) SA 532 (SCA) at 537A–D; *Noormohamed v Visser* 2006 (1) SA 290 (SCA) at 295G.

<sup>18</sup> Christie & McFarlane *Law of Contract* at 471.

<sup>19</sup> See par 3.3.2.1. See also Scott *Cession* at 163–164.



rights will have to be negotiated as part of the delegation in order for the new party to gain secured claims.<sup>20</sup>

As indicated above, the requirement of Securitisation Notice, 2008 that both rights and obligations must be transferred necessitates that delegation must be the method of transfer of the claims to the SPV. In my opinion, this is a major flaw in the Notice, which should be removed.

I consider it unwise for the SPV to acquire duties. First, it will mean that the debtor must not only be informed of the transfer, but must also give his consent for the replacement of his debtor with another party. If the original agreement was in writing and contained a standard non-variation clause, the written agreement will have to be substituted for a new one. This has administrative, time-delay and cost implications. Second, the SPV may be unable to fulfil these duties in terms of the limitations stated in its objects clause. Lastly, the SPV is not supposed to engage in business outside of the securitisation scheme in order to minimise the risk of its insolvency.

Securitisation Notice, 2008 further foresees the possibility of securitising an 'undrawn commitment' to lend money to a borrower.<sup>21</sup> In such a case the only possibilities for the transfer of the undrawn commitment allowed by Securitisation Notice are novation, assignment or any other means specified in writing by the Registrar. I submit that 'assignment' carries the meaning set out above and should really read 'delegation'.

I suspect that the reason why Securitisation Notice, 2008 places such emphasis on a severance of ties between the debtor and the originator is that it fears that an ongoing business relationship between the debtor and the originator might lead to a conclusion that the transaction was not a true sale. In reality most originators want to continue their business relationship with the debtor. Even if the duties arising from agreements with the debtors are transferred to the SPV as foreseen by the Notice, the SPV will not be in a position to actively participate in the fulfilment of those duties. An SPV has, per definition, only a limited main objective, namely to raise money from the public, backed by the assets transferred to it by the originator. It does not have capital available to meet lending obligations of the sort that Securitisation Notice

<sup>20</sup> See the discussion in par 7.2.3 below.

<sup>21</sup> Schedule, par 4(2)(i). The term 'undrawn commitment' is not defined in the Notice, but I submit that it refers to the duty to lend money to the borrower in future, which will give rise to future claims against the borrower.

foresees, nor does it maintain the personnel to administer and manage an ongoing business relationship with a debtor.<sup>22</sup> The transfer of these duties to the SPV will further mean that it incurs liability for duties apart from its duties towards the investors, which defeats the objective of an insolvency-remote SPV.

In my opinion, the inclusion of a transfer of duties in Securitisation Notice, 2008, might, rather than safeguard against a finding of a non-true sale, have the opposite result. Suppose the SPV raises the additional capital required to function as a lender and service the duties of undrawn commitments as foreseen by the Notice. The SPV will not have staff or the administration to manage these new loans and will most likely allow the originator, whether it is the servicer or not, to manage this relationship on its behalf. The retention of servicing rights by an originator is expressly excluded as a form of indirect control over the assets by Securitisation Notice, 2008.<sup>23</sup> ‘Servicing agent’ is defined in the Notice as “an institution that acts as servicing agent in relation to the collection of the amounts due in terms of a traditional or synthetic securitisation scheme”.<sup>24</sup> I submit that this definition only covers the collection of amounts due and does not make provision for the administration of ongoing lending activities.

In actual fact Securitisation Notice, 2008 contradicts itself by expecting, on the one hand, that all rights and duties be transferred to the SPV and, on the other hand, forcing the SPV by implication to leave the management and administration of those rights and duties with the originator. A further contradictory provision of Securitisation Notice is the following:<sup>25</sup>

The agreement between the institution transferring the assets in terms of a traditional securitisation scheme and the special-purpose institution shall be such that, in the event of the terms of an underlying transaction being amended, the special-purpose institution, and not the transferring institution, or any of the transferring institution’s associated companies or, when the transferring institution is a bank, any other institution within the banking group of which such a bank is a member will be subject to the terms so amended.

This paragraph assumes delegation. The amendment of the underlying agreement to the effect that the SPV, and not the originator, is bound assumes that the debtor consented to a substitution of lenders. Second, although it does not expressly state

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<sup>22</sup> See also my comments on the transfer of a covering bond in par 7.2.3.1.

<sup>23</sup> Schedule, par 4(2)(b)(iii).

<sup>24</sup> Schedule, par 1.

<sup>25</sup> Schedule, par 4(2)(j).

this, the paragraph suggests that the debtor will continue to deal with the originator. If this was not the case and the debtor dealt directly with the SPV, the amendment of the underlying transaction would be a new agreement between the debtor and the SPV and the paragraph would become superfluous. It seems then that the paragraph foresees that the debtor will amend the terms of the underlying agreement through negotiation with the originator, but that the SPV will be bound by the terms of the varied agreement.

I submit that this paragraph grants the originator blanket consent to act on behalf of the SPV in the variation of the terms of the underlying transaction. Despite the efforts of Securitisation Notice, 2008, to separate the corporate governance of the SPV from the control of the originator,<sup>26</sup> this paragraph allows that acts by the originator will bind the SPV. This paragraph also foresees the transfer of rights and duties that flows from the business relationship between the debtor and the originator.

In my opinion, the peremptory language used in Securitisation Notice, 2008 to imply that the transfer of the assets must be in the form of a delegation is unfortunate. It ought to be possible for an originator to transfer the claims arising from the underlying transactions, but to remain liable for any outstanding duties, and to still qualify for the exemption provided for by the Notice.<sup>27</sup> The current wording of the Notice suggests that cession alone will only be acceptable for the transfer of the assets to the SPV when there are no longer any duties owing to the debtor. This will be the case where the originator and the debtor's business relationship have come to an end. This does not serve the purposes of the originator, who wants to acquire financing whilst maintaining a business relationship with its borrowers.<sup>28</sup>

An example of the problems that may arise by transferring duties as prescribed by Securitisation Notice, 2008 is the securitisation of equipment leases. One may distinguish between two forms of lease agreements. First, 'finance lease' refers to a transaction where the lessor leases equipment to the lessee, but where substantially all of the risks of the ownership of the equipment are transferred to the lessee regardless of whether the lessee will become the owner of the equipment after expiry of the lease

<sup>26</sup> See pars 6.2.3, 6.2.4 and 6.2.5.

<sup>27</sup> See par 6.2.5.

<sup>28</sup> See in this regard my comments on the securitisation of covering bonds in par 7.2.3.1.

term.<sup>29</sup> Second, under an ‘operating lease’, the lessee is only liable for payment of the periodic lease payments and there is no substantial transfer of the risk and rewards of ownership from the lessor. The lessee under an operating lease will usually not bear the risk of maintenance of the leased equipment.<sup>30</sup> There may further be an obligation on the lessor to replace equipment that becomes outdated or which cannot be repaired.

At present, duties such as the continued maintenance of the equipment under operating leases will have to be delegated to the SPV when the lease agreements are securitised. These may be very onerous duties for which the SPV is not suited. It would have been preferable to leave these duties with the originator and to only transfer the claims under the lease agreements to the SPV.

#### 7.2.2.2 Cession

Cession is an act of transfer whereby a creditor (the cedent) transfers his claim against his debtor to a third person (the cessionary) in such a way that the cessionary becomes the creditor of the debtor.<sup>31</sup>

There must be a valid transfer agreement between the cedent and the cessionary for the cession to take effect. In other words, the cedent must have the intention to transfer the claim to the cessionary and the cessionary must have the intention to receive the claim.<sup>32</sup>

##### 7.2.2.2.1 Delivery of document

Before the judgment of the Appellate Division in *Botha v Fick*<sup>33</sup> there was uncertainty whether a claim evidenced in a written document could only be ceded if the document was also delivered to the cessionary. Some courts argued that such delivery was a requirement, which developed through the incorporation into our law of the English law doctrine of all effort.<sup>34</sup> The doctrine of all effort states that the cedent must do

<sup>29</sup> See Van der Merwe *et al Business Administration* (2008) at 20-8.

<sup>30</sup> Of course, one must have regard to the terms of the specific lease. According to Van der Merwe *et al Business Administration* at 20-10 lower priced equipment operating leases may require maintenance by the lessee.

<sup>31</sup> *Scott Cession* at 1; *Johnson v Incorporated General Insurance Ltd* 1983 (1) 318 (A) at 331G-H.

<sup>32</sup> *Scott Cession* at 24-25; Nienaber in Joubert *et al LAWSA* at 19-20.

<sup>33</sup> 1995 (2) 750 (A).

<sup>34</sup> *Smith v Farrelly's Trustee* 1904 TS 949 at 956; *Jeffrey v Pollak and Freemantle* 1938 AD 1 at 22, 24; *Labuschagne v Denny* 1963 (3) SA 538 (A) at 543H-544B; *Trust Bank of Africa Ltd v Standard Bank of SA Ltd* 1968 (3) SA 166 (A) at 712D-173D, 185A-D; *Roman Catholic Church (Klerksdorp*

everything in his power to divest himself of his right. The inclusion of this doctrine into South African law as a requirement for cession has been criticised by Scott<sup>35</sup> as based on confusion with the requirement of a deed of cession in Roman-Dutch law.

*Botha v Fick* brought an end to this uncertainty.<sup>36</sup> The Appellate Division held that delivery of the document was not a requirement for the cession of a claim<sup>37</sup> and that the doctrine of all effort did not find application where the document only evidenced a claim.<sup>38</sup>

However, if the assets transferred during a securitisation transaction take the form of commercial paper, shares or other securities, it remains prudent, in my opinion, that the originator must ensure that certificates relating to those securities, as well as the transfer documents as required by the Companies Act<sup>39</sup> and by the articles of association of the issuer, are delivered to the SPV.<sup>40</sup> The obligatory agreement should specifically provide for the transfer of the securities into the name of the SPV.

In an article criticising the decision in *Botha v Fick*, Kritzinger<sup>41</sup> raises the valid argument that the Court failed to distinguish between the transfer in ownership of the shares and the right to be registered as a member of the company.<sup>42</sup> The author argues that since registration as a member of the company is necessary before a purchaser of shares can enforce his rights against third parties, especially the issuer, the purchaser

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*Diosece v Southern Life Association Ltd* 1992 (2) SA 807 (A) at 813C–D. See further Scott *Cession* at 27–39; AN Oelofse “Lewering van die Dokument waaruit die Reg Blyk as Geldigheidsvereiste vir Sessie” 1990 (53) *THRHR* at 61 *et seq.* In *Labuschange* the Court held at 544A–B that the rule only has application where there is more than one cessionary who claim to be the rightful holder of the claim. The delivery of the document was, according to this decision, not a requirement for the validity of the cession between the cedent and the cessionary. However, this case concerned delegation. The claim is extinguished through delegation, and the delivery of the document is therefore not at issue (at 544C–E). The comments about delivery of the document were *obiter*.

<sup>35</sup> Scott *Cession* at 27 and 40–43; Susan Scott “Delivery of Document as Validity Requirement for Cession” 1995 *TSAR* at 760.

<sup>36</sup> For a discussion and criticism of this case, see Scott 1995 *TSAR* at 760; Scott 1998 *THRHR* at 92–96; Konrad M Kritzinger “Share Transfer by Mere Consensus?” (1995) 122 *SALJ* at 389. See also Nienaber in Joubert *et al* *LAWSA* at 25.

<sup>37</sup> At 765E and 776D.

<sup>38</sup> At 776J–777D.

<sup>39</sup> 61 of 1973.

<sup>40</sup> Section 42 of the Securities Services Act 36 of 2004 provides for the transfer of uncertificated securities by means of an entry in the central securities account or the securities account of the transferor and transferee. See also Scott 1995 *TSAR* at 762.

<sup>41</sup> Kritzinger 1995 *SALJ* at 393–395.

<sup>42</sup> Oelofse 1990 *THRHR* at 70 is of the opinion that this confusion lies at the heart of many of the contradictory decisions of the courts prior to *Botha v Fick*.

will not completely step into the shoes of the seller until such registration has occurred.<sup>43</sup> In other words, the cession will not be complete until registration of the purchaser as the member of the issuer.

While I agree that the company need only take cognisance of the members as reflected on its register of members,<sup>44</sup> I do not agree with Kritzinger that failure to register as a member will effectively mean that the purchaser cannot enforce his rights in the shares against the execution creditors of the seller or his trustee in insolvency. It should be noted, however, that Kritzinger's article appeared before section 140A of the Companies Act was introduced. This section requires a person who is registered as the holder of securities, but who is, in fact, not the beneficial owner of the securities registered in his name, to disclose every three months who the beneficial holders of the securities are.<sup>45</sup> The company must keep a list of these beneficial holders, which is open for inspection by the public just like the register of members.<sup>46</sup>

If the seller and the purchaser therefore agree that the former will remain registered as the member of the company, the seller will have to make these declarations and third parties will be privy to this information.

I further disagree with Kritzinger's<sup>47</sup> opinion that the court does not have the discretion to order the rectification of the register where the proper formalities for such registration have not been complied with. One should distinguish between the formalities required by the Companies Act and the articles of association of the company for the transfer of securities,<sup>48</sup> and the entitlement of the purchaser of those securities to have his name entered into the relevant register. Where the parties agreed that the purchaser will be registered as a member of the company, but the necessary transfer documents were not delivered to the purchaser or the purchaser has lost them, the court, in my opinion, is empowered by section 115(3) to order rectification of the

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<sup>43</sup> Kritzinger 1995 *SALJ* at 394–395. The author is of the opinion that the beneficial owner of shares is more akin to the beneficiary of a trust than to a cessionary, but does not take into account that South African law does not acknowledge constructive trusts.

<sup>44</sup> Section 103(3) of the Companies Act 61 of 1971.

<sup>45</sup> Section 140A(3).

<sup>46</sup> Section 140A(8).

<sup>47</sup> Kritzinger 1995 *SALJ* at 399.

<sup>48</sup> See ss 105, 128 and 133–140.

register.<sup>49</sup> The court can order specific performance of the contract between the parties. To further require that the formalities of the Companies Act and the articles of association need still be complied with before registration could be affected is absurd and could not have been the intention of the legislature.

It is possible during a securitisation of securities that the originator could remain the nominee of the SPV on the register of the issuer of the transferred securities. The originator would then have to make the disclosures as envisioned by section 140A. The agreement between the originator and the SPV should then clearly indicate that the originator is acting as the SPV's agent when exercising any membership or other rights conferred by the transferred securities.

However, I prefer that all formalities for the transfer of the securities should be complied with, in order to avoid any semblance of involvement by the originator in the rights conferred by the securities.<sup>50</sup>

#### 7.2.2.2.2 *Valid causa*

A valid *causa* is a requirement for the validity of a cession.<sup>51</sup> In the case of a securitisation, the contract of sale will be the *causa* for the cession of the claims. However, South African law adheres to an abstract system for the transfer of ownership<sup>52</sup> and Scott is of the opinion that the abstract system is also preferable for the transfer of personal rights.<sup>53</sup> In an abstract system the right passes to the estate of

<sup>49</sup> The relevant part of the section reads as follows: "On any application under this section the Court may decide any question relating to the title of any person who is a party to the application to have his name entered into or omitted from the register, ... and generally may decide any question necessary or expedient to be decided for the rectification of the register."

<sup>50</sup> Stamp duty will be payable in terms of s 23 of the Stamp Duties Act 77 of 1968. See also s 133(4) of the Companies Act 61 of 1973.

<sup>51</sup> *Johnson v Incorporated General Insurance Ltd* 1983 (1) 318 (A) at 331G–H, cited with approval in *Botha v Fick* 1995 (2) SA 750 (A) at 762B–C.

<sup>52</sup> See ch 5 n 155.

<sup>53</sup> Scott *Cession* at 84–85. *Inter partes* it does not make much of a difference whether the abstract or the causal system of transfer applies. If the right is transferred regardless of the validity of the obligatory agreement, the cedent will claim the right back in terms of unjust enrichment. If the right is only transferred when there is a valid obligatory agreement, the right will still be in the estate of the cedent when it becomes clear that there was no *causa*. The choice of system of transfer is really only important for the protection of third parties, including the debtor. In the abstract system the claim will fall in the estate of the cessionary in the event of his insolvency, regardless of the invalidity of the obligatory agreement. A *bona fide* third person can only acquire a right from someone who is the legal holder of that right, which implies that such persons are protected through the application of the abstract system. Also, in the causal system a debtor will have to enquire into the validity of the obligatory agreement if he wants to make payment to the cessionary after receiving notice of the cession. Otherwise, the cedent may claim performance from the debtor when

the cessionary regardless of the validity of the underlying *causa* (obligatory agreement).

In the context of securitisation the abstract system benefits third parties involved in the scheme, especially the investors who rely on the claims as security for their investment. If the claims were not transferred to the SPV, no valid security would have been created in favour of the investors.<sup>54</sup> Owing to the operation of the abstract system of the transfer of rights, the invalidity of the contract of sale will not affect the transfer of the claims to the SPV. Should the SPV be declared insolvent, the investors will have secured claims against the insolvent estate, whereas the originator will have a concurrent claim against the insolvent estate based on unjust enrichment.

#### 7.2.2.2.3 Role of notice to debtor

A claim is dualistic in nature in that it relates both to the law of property and to the law of obligations.<sup>55</sup> The claim forms part of the estate of its holder and it is also aimed at performance by the debtor. Accordingly, cession leads to a shifting of the claims from the estate of the cedent to the estate of the cessionary, which relates to the law of property. It also causes a substitution of creditors, which relates to the law of obligations. However, South African courts are not always careful to note this distinction.<sup>56</sup> This dual nature of cession is important when one considers whether notice to the debtor is a requirement for a valid cession.<sup>57</sup>

A cession is complete *inter partes* without notice to the debtor.<sup>58</sup> In other words, the transfer of the assets from the estate of the cedent to that of the cessionary is affected by the agreement between them without the need to notify the debtor.

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it emerges that there was no valid obligatory agreement. This substantially burdens the position of the debtor. See also Scott 1998 *THRHR* at 98–102; DSP Cronjé “Die Saaklike Ooreenkoms by die Eiendomsoordrag van Roerende Sake” 1978 (41) *THRHR* at 243; Schutte 2008 *TSAR* at 66; Nienaber in Joubert *et al LAWSA* at 21; Badenhorst *et al Silberberg* at 78–79.

<sup>54</sup> In terms of the rule *nemo plus iuris ad alium transferre potest quam ipse habet*, D 50 17 54, a person cannot transfer more rights than he himself has.

<sup>55</sup> Scott *Cession* at 101–104; Susan Scott “Die Rol van Kennis van Sessie aan die Skuldenaar” (2007) *TSAR* at 819; Scott 1997 *THRHR* at 641; Scott 1998 *THRHR* at 102–106; Nienaber in Joubert *et al LAWSA* at 9.

<sup>56</sup> See for instance *Rothschild v Lowndes* 1908 TS 493 at 499; *Katz v Katzenellenbogen* 1955 (3) SA 188 (T) at 190H–191B; *Brook v Jones* 1964 (1) SA 765 (N) at 766H–767A; Scott *Cession* at 109–110.

<sup>57</sup> For an in depth discussion of the role of notice to debtors during cession, see Scott *Cession* at 92 *et seq.*

<sup>58</sup> Scott 2007 *TSAR* at 820. See also Nienaber in Joubert *et al LAWSA* at 5.



However, before the debtor receives notice of the cession from the cedent<sup>59</sup> the debtor is discharged by payment to the cedent.<sup>60</sup>

If the originator continues to act as servicer for the SPV the lack of notice to the debtors of the securitisation does not pose any real problems as far as discharge goes.<sup>61</sup> The debtors will continue to pay the originator, now in its capacity as servicer. However, if a third party is brought in to act as servicer for the SPV, debtors should be notified of the cession and to whom they should make payment. In the absence of such notice, the debtors could continue to discharge their debts by payment to the originator. However, in practice the introduction of a third party servicer will usually result in the need to inform the debtors that they must in future pay another party, which might as well include notice of the cession.

#### 7.2.2.2.4 Set-off

A debtor can raise set-off<sup>62</sup> against a cessionary if set-off could have operated against the cedent before notice of the cession was given.<sup>63</sup> This means that the debtor can

<sup>59</sup> Notice must come from the cedent, because it is the only reliable confirmation to the debtor of the cession. Otherwise the debtor will need to verify every notification of a cession. See Scott *Cession* at 107–108; Scott 1998 *THRHR* at 97 and 104.

<sup>60</sup> Courts usually rely on Voet *Commentarius* 18 4 15: “Nay indeed it is obvious from the passage next cited next below (D II 15, 17) that if the debtor was not unaware of the sale and cession, but all the same notice had not yet been given him by the cessionary, he does not indeed make an effective compromise with the cedent. But no reason of law forbids him to make payment in good faith to the cedent and thus to be released. He certainly pays the person to whom he was under obligation. So long as no notice at all has taken place, the act of a third party cannot stand in his way. The cessionary ought to put it down to himself if he is in loss because of his neglect or delay in giving notice.” See also *Illings (Acceptance) v Ensor NO* 1982 (1) SA 570 (A) at 578F. The Courts provided two possible reasons why a debtor will receive discharge by payment to the cedent when he has not received notice of the cession, namely estoppel (*Katz v Katzenellenbogen* 1955 (3) SA 188 (T) at 191B) and good faith. Scott 2007 *TSAR* at 820–822 prefers the approach based on good faith as held in *Brook v Jones* 1964 (1) SA 765 (N) at 767D–F. A debtor makes payment to a cedent in good faith if he is under the impression that he must pay that person, whilst having reasonable grounds for such a belief. The debtor does not receive discharge because of the absence of formal notice, but because he was not aware of the cession. See further Nienaber in Joubert *et al LAWSA* at 38–39.

<sup>61</sup> For the position relating to set-off, see below.

<sup>62</sup> The requirements for set-off is that the claims must be reciprocal and that both claims must be liquid and due. See *Richter v Riverside Estates (Pty) Ltd* 1946 OPD 209 at 224.

<sup>63</sup> Voet *Commentarius* 16 2 4: “Set-off can take place also against cessionaries who sue on a ceded action, not only in respect of what they themselves owe in their own names to him against whom they are proceeding on the action ceded, but also in regard to what the cedent himself owes them on his side, provided that he owed it before the cession, and thus set-off could have been raised against him. Since the debt disappeared *ipso jure* according to what was said above up to a corresponding amount on both sides at the very moment at which something started to be due on both sides, the action against the debtor could not have been ceded except as regarded the share which remained to

continue to set-off any claims he has against the originator that comply with the requirements of set-off until he receives notice of the cession.

The potential of set-off does not bar the use of a claim during securitisation, but the risk of set-off must be considered when provision is made in the scheme for credit enhancement.<sup>64</sup>

#### 7.2.2.2.5 Defences

Generally, all real defences that were available to the debtor against the cedent are also available against the cessionary.<sup>65</sup> The non-payment of claims due to the successful reliance on defences by debtors will be taken into account during the assessment of the quality of the assets to be transferred to the SPV by the rating agency and in deciding on the credit enhancements that must be included in the structure of the scheme. If these measures are in place as they should be, possible defences of debtors should not be a major obstacle to the success of a securitisation scheme.

#### 7.2.2.2.6 Case for codification

Scott<sup>66</sup> has argued that the South African law of cession is in need of statutory intervention to clarify certain aspects, such as the role of notice to the debtor, the possible need for a formal deed of cession and the effect of the absence of a valid *causa* for the cession.

Her argument rests on two pillars. First, she argues that modern law of cession developed from nineteenth-century German law and that the earlier Roman-Dutch authorities therefore do not provide authority for the modern law of cession.<sup>67</sup> Second, for various reasons over time South African courts have delivered such conflicting

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be collected after the debits and credits had been merged and so wiped out.” See also Scott *Cession* at 115; Nienaber in Joubert *et al* LAWSA at 44–45.

<sup>64</sup> See par 2.5.

<sup>65</sup> *London & South African Bank v The Official Liquidator of the Natal Investment Co* 1871 NLR 1 at 3; *Biggs v Molefe* 1910 CPD 242 at 251; *Walker v Syfret NO* 1911 AD 141 at 162; *Van Zyl v Credit Corporation of SA Ltd* 1960 (4) SA 582 (A) at 588F–H; Nienaber in Joubert *et al* LAWSA at 41–42.

<sup>66</sup> Scott 1997 *THRHR* at 179; 1997 *THRHR* at 434; 1997 *THRHR* at 633; 1998 *THRHR* at 88. See also the comment of Olivier JA in *First National Bank of South Africa v Lynn* 1996 (2) SA 339 (A) at 360E.

<sup>67</sup> Scott 1997 *THRHR* at 634–636.

decisions on the contentious issues of cession, that they can no longer on their own bring cession in line with the needs of commerce.<sup>68</sup>

I do not intend to consider in depth whether such intervention is necessary, except to mention that any future legislation dealing particularly with cession would need to take cognisance of the issues surrounding securitisation. For instance, the scale on which claims are ceded during the securitisation process is so great that it makes suggestions such as itemised deeds of transfer impractical.<sup>69</sup>

### 7.2.3 Transfer of security rights

A real security right is dependent on the principal debt for which it was created. This is referred to as the accessory nature of real security rights and the principle has long been accepted as part of South African law.<sup>70</sup>

I have on another occasion researched the accessory nature of security rights in South African law.<sup>71</sup> I will therefore only summarise my previous conclusions and apply them to the position during securitisation.

In South African law a real security right is dependent on a principal debt for its existence. In other words, a real security right cannot be created if the claim it secures is not yet in existence and it cannot continue to exist after the claim has ceased to exist.<sup>72</sup>

The exception to this rule is a covering bond that complies with section 51 of the Deeds Registries Act.<sup>73</sup> In terms of this section a mortgage bond or a notarial bond registered to secure a future debt will only give its holder a preference or priority if the bond specifically stipulates that it is intended to secure future debts generally or a particular future debt, and if there is an amount stipulated in the bond above which

<sup>68</sup> Scott 1997 *THRHR* at 637–639.

<sup>69</sup> See Scott 1998 *THRHR* at 96–97. I agree with Scott that the very formal requirements for the transfer of land as opposed to the lack of formalities for the transfer of claims do not make sense in the context of the modern commercial world. I further agree that a deed of transfer could create greater certainty about whether a cession was intended.

<sup>70</sup> *Kilburn v Estate Kilburn* 1931 AD 501 at 506: “It is therefore clear that by our law there must be a legal or natural obligation to which the hypothecation is accessory. If there is no obligation whatever there can be no hypothecation giving rise to a substantive claim.” This principle was subsequently affirmed in *Thienhaus v Metje & Ziegler Ltd* 1965 (3) SA 25 (A) at 32F–G.

<sup>71</sup> Natania Strydom *Die Aksessoriteitsbeginsel in die Suid-Afrikaanse Reg* (2000 dissertation University of Johannesburg).

<sup>72</sup> Strydom *Die Aksessoriteitsbeginsel* at 53 *et seq* and the authority cited there.

<sup>73</sup> 47 of 1937.

future debts shall not be secured by the bond. Since there is a continuous possibility of future claims, the bond in terms of section 51 will continue to exist even when the balance on a particular moment is zero.

The accessory nature of a real security right does not mean that it will necessarily follow the principal debt when the latter is ceded.<sup>74</sup> In South African law there must be a separate transfer of the real security right to the cessionary of the principal debt. A valid transfer can only be affected through a new real agreement<sup>75</sup> and by giving proper publicity to the transfer.<sup>76</sup> The requirement of a new real agreement implies that the security grantor must cooperate for the transfer to take effect. The original holder of the security will not be entitled to transfer the real security rights without the co-operation of the security grantor.<sup>77</sup>

Provision is made in the Deeds Registries Act for the registration of a transfer of mortgages and bonds,<sup>78</sup> which provides a transfer with proper publicity. Specific provision is also made for the registration of a cession of covering bonds.<sup>79</sup> When the requirements of the Deeds Registries Act for the transfer of mortgages and bonds are met, the transfer will not affect the priority of the security taker. The same result is not possible for a transfer of a pledge, where the new pledgee will only have priority from the time that the requirements of the transfer of the pledge are met.<sup>80</sup>

<sup>74</sup> In the Netherlands the security right will follow the claim *ipso iure*. See Strydom *Die Aksessoriteitsbeginsel* at 26–27; Scott *Cession* at 130. In German law provision is made specifically in the *Bürgerliches Gesetzbuch* for the automatic transfer of the security right with the underlying claim when the latter is ceded (§1205(1); § 1153(1) and (2)). See further Strydom *Die Aksessoriteitsbeginsel* at 39–44; JC Sonnekus “Sessie van Saaklike Sekerheidsregte?” (1997) *TSAR* at 773; Scott *Cession* at 130; *Louw v WP Koöperatief Bpk* 1994 (3) SA 434 (A) at 442J–443B. On derivative acquisition of real right generally, see Badenhorst *et al Silberberg* at 72–80.

<sup>75</sup> Most South African authors, as well as the Courts, seem to put the emphasis on the publicity of the transfer of the real right. See Scott & Scott *Wille’s* at 77; Scott *Cession* at 130; De Wet & Van Wyk *Kontraktereg 5 ed* at 405–406; *Shaw NO v Burger* 1994 (1) SA 529 (C) at 534B–C; *Lief v Dettmann* 1964 (2) SA 252 (A) at 273H. See, however, Sonnekus 1997 *TSAR* at 774. On the real agreement in general, see Cronjé 1978 *THRHR* at 227 *et seq*; Schutte 2008 *TSAR* at 66.

<sup>76</sup> *Info Plus v Scheelke* 1998 (3) SA 184 (SCA) at 189E.

<sup>77</sup> In accordance with the maxim “*nemo plus iuris transferre potest quam ipse habet*”, no one can transfer more rights to another than he himself has.

<sup>78</sup> Sections 3(f), 3(j) and 16.

<sup>79</sup> Section 52: “A cession of a mortgage bond or notarial bond passed to secure future advances may be registered and the registration of such cession shall not affect the provisions of the bond relating to future advances up to the amount stated in such bond or the amount as reduced.”

<sup>80</sup> Strydom *Die Aksessoriteitsbeginsel* at 63–64. Pledge is not a form of security often used during securitisation and will not be further discussed.

When the principal debt is ceded without the requirements for the transfer of the security right being met, the security right will cease to exist.<sup>81</sup> This is because a security right cannot continue to exist without the claim it aims to secure. Furthermore, if the claim ceases to exist, so will the security right.

Delegation is a form of novation. Novation brings an end to a claim and the claim is replaced with a new claim. During delegation the security rights that secured the original claim will cease to exist together with the claim. A new security right must be created with the creation of the new claim.

As was discussed above,<sup>82</sup> Securitisation Notice, 2008 implies delegation as the form of transfer of assets to the SPV. When the assets are claims secured by accessory security rights, both the claims and the security rights will cease to exist after the delegation. It must therefore be concluded that all accessory security rights held by the originator before transfer of the claims to the SPV cease to exist on transfer. Unless specified otherwise, my comments below apply to the situation where the claims are transferred to the SPV by means of cession.

It is important to remember the requirements for the transfer of the real security rights during the securitisation of mortgage bonds or claims secured by notarial bond. Today most standardised mortgage agreements already contain a clause whereby the mortgagor consents to the transfer of the mortgage. While it may be argued that the mortgagor could change his mind before the transfer, in my opinion South African courts will keep the mortgagor to his expression of will in the written documentation.<sup>83</sup> If the claims are ceded to the SPV, such consent should suffice. The originator will further have to comply with the registration requirements of the Deeds Registries Act to publicise the cession of the mortgage bonds.

If the claims and the duties owing to the debtor are delegated to the SPV, the debtor will have to consent to the creation of a new security right. Whether such consent was given in the original agreement will be a matter of interpretation of the agreement. However, since the previous security right is terminated, the new mortgage or special notarial bond should be registered again, and not ceded. This influences the priority that the security provides its holder, because priority is

<sup>81</sup> This is also the opinion of Scott *Cession* at 131 and Sonnekus 1997 *TSAR* at 779–780.

<sup>82</sup> Paragraph 7.2.2.1.

<sup>83</sup> See the position with regards to instalment sale agreements in par 7.2.3.4.

determined according to the date of registration of the mortgage or special notarial bond. This is another reason why delegation should not be the method by which the assets are transferred to the SPV. It should be possible to only cede the claims, so that the accessory security rights may continue to exist and may be transferred to the SPV without losing their priority.

This would be the situation during a securitisation where a fixed amount is secured by mortgage or notarial bond. However, the transferability of the accessory rights becomes more complicated when the claims under a covering bond are transferred.<sup>84</sup>

#### 7.2.3.1 Covering bonds

A covering bond secures the balance of the claims that flow from, and the payments made during, an ongoing business relationship between the creditor and the debtor.<sup>85</sup> The bond is not affected by a zero balance at any given time, because the contract between the debtor and creditor still has the possibility of creating new claims.

If the contract between the creditor and the debtor is terminated the bond will change from a covering bond to a fixed bond, securing the claim that reflects the balance at the moment of termination of the contract. The cession of this claim with its accessory bond will be executed in the manner explained above and poses few problems. It is further possible that the rights and duties of the contract that gave rise to the business relationship between the original creditor and debtor are transferred. The covering bond can be transferred to the cessionary in terms of section 52 of the Deeds Registries Act, retaining priority at the date of registration of the bond. This also does not pose a problem generally, but does in the case of securitisation, as I shall explain below.

However, most credit institutions will not want to end the business relationships with their clients after the securitisation. What they want to do is to cede the balance at a particular moment to the SPV, while retaining the possibility of future advances to the debtor by keeping the contract with the client. The credit institution will want to retain the bond to secure future claims against the debtor. The bond cannot be split to

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<sup>84</sup> See in general Strydom *Die Aksessoriteitsbeginsel* at 65 *et seq.*

<sup>85</sup> Strydom *Die Aksessoriteitsbeginsel* at 74–75. Here I argued that the balance is a new claim created by novation, which means that the individual claims resulting from the credit relationship no longer exist. See further GF Lubbe “Die Aksessoriteitsbeginsel en die Sessie van Dekkingsverbande” (1987) 20 *De Jure* at 243; CG van der Merwe & Eric Dirix “A Comparative Law Review of Covering Bonds and Mortgages Securing Fluctuating Debts” (1997) 8 *Stell LR* at 19.

cover claims owed to two creditors, as this is prohibited by section 50(5) of the Deeds Registries Act.<sup>86</sup> It would in effect be an illegal participation bond.<sup>87</sup>

The only way in which it could be made possible for the mortgage to split, so that the mortgage could secure the fixed claim that is ceded to the SPV as well as future advances by the originator, is through legislation. However, even if the division of the bond is enabled by legislation, for instance through an amendment to the Deeds Registries Act, the ongoing relationship between the originator and the debtor leaves certain questions. Where the originator acts as servicer, it will have to be determined whether payments made by the debtor will serve first as payment of the transferred claims or as payment of debts owed to the originator. Furthermore, the fixed amount transferred to the SPV will have to be subtracted from the maximum amount that the bond will cover; otherwise it will mean that the originator could again advance money to the debtor up to the maximum amount. The total amount owing will then be the ceiling amount plus the fixed amount transferred to the SPV, which will mean that the bond is not adequate to secure the full amount outstanding.

All of this could, of course, be addressed through careful planning. What is more problematic is whether the splitting of the bond in favour of two creditors should be allowed, or disallowed, based on policy considerations. The encumberment of the property of the debtor in favour of two creditors where there was previously only one, increases the burden of the debtor.<sup>88</sup> Even if the debtor consented in the original bond agreement to the transfer of the bond, the debtor probably did not foresee that such a transfer could be only partial and that the bond could be split in favour of more than one security holder.

The registration of the transfer of the covering bond envisaged in section 52 seems to me to indicate a transfer of both rights and duties, since it makes provision for future advances. The SPV, however, does not have the capacity or the capital to conduct the business of a credit provider.<sup>89</sup>

<sup>86</sup> The section reads as follows: "Save as authorized by any other law or by order of Court, debts or obligations to more than one creditor arising from different causes may not be secured by one mortgage bond or notarial bond."

<sup>87</sup> On participation bonds generally, see the Collective Investment Schemes Control Act 45 of 2002, ss 52–61. Van der Merwe & Dirix 1997 *Stell LR* at 27 recognise this situation as problematic, but do not attempt to provide a solution.

<sup>88</sup> Cession must not affect the debtor adversely. See Nienaber in Joubert *et al LAWSA* at 31.

<sup>89</sup> See par 2.3.

The originator could transfer the covering bond to the SPV and cede the claims that arise under its business relationship with the debtor to the SPV as they arise. In other words, the claims as they arise are ceded to the SPV, but the originator remains liable for the duties under the original agreement with the debtor. Under such an arrangement the originator should be aware that it no longer has secured claims against the debtors whose covering bonds were ceded. Since it sells those claims to the SPV, the risk it takes by transferring the bond is small.<sup>90</sup> More problematic is the fact that Securitisation Notice, 2008 does not make provision for the transfer of only the claims, but requires that the duties towards the debtors must also be transferred to the SPV.<sup>91</sup> This arrangement is therefore not currently allowed in South African law.<sup>92</sup>

I submit that Securitisation Notice, 2008 ought to be amended so that it is not necessary for the obligations towards the debtor to also be transferred. The arrangement set out above will then be possible. However, I am not sure that the banking industry will be keen to part with the covering bonds in their favour, even if the securitisation process means that they carry less risk in terms of their relationship with the debtors.

#### 7.2.3.2 Sureties<sup>93</sup>

In *Pizani v First Consolidated Holdings (Pty) Ltd*<sup>94</sup> the Appellate Division held that the cessionary of a claim that is secured by way of surety steps into the shoes of the cedent, also with regards to the suretyship. In other words, it is not necessary to enter into a separate agreement to cede the claims in terms of the suretyship. The suretyship follows the claim automatically.

If the agreement of suretyship contained a *pactum de non cedendo* the right against the surety will not pass to the cessionary. When the claim is ceded to the SPV, the suretyship will cease to exist.<sup>95</sup>

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<sup>90</sup> The exception is where the bond secures all amounts owing to the originator “arising from any cause whatsoever”, and the debtor owes the originator considerable sums outside of the claims transferred to the SPV. See Van der Merwe & Dirix 1997 *Stell LR* at 19.

<sup>91</sup> See the discussion and criticism of this rule in par 7.2.2.1.

<sup>92</sup> Unless the SPV is prepared to register as a deposit-taking institution. This has immense capital requirements and is subject to strict supervision.

<sup>93</sup> For the definition of suretyship, see par 5.4.1.

<sup>94</sup> 1979 (1) SA 69 (A) at 77B–C.

<sup>95</sup> See Strydom *Die Aksessoriteitsbeginsel* at 138–140; Scott *Cession* at 129.



However, as is the case with accessory real security rights, the suretyship will come to an end when the claim ceases to exist. The same criticism that applies to the effect of delegation on accessory real security rights therefore applies to suretyship.

### 7.2.3.3 Security by way of cession *in securitatem debiti*

Fiduciary security cession of claims is a non-accessory form of security. If the principal debt is ceded to the SPV, the originator will still be the legal holder of the claims that act as security. There will have to be an agreement to cede the claims that serve as security between the originator and the SPV. The permission of the debtor is not necessary to effect such a cession. It is also not necessary to inform the security grantor, because the claims were transferred to the originator, who is entitled to transfer the claims again. The security grantor only retains a reversionary interest in the claims.<sup>96</sup>

The position differs where the transferred claims are secured by way of a pledge of claims. During a pledge of claims the claims remain in the estate of the pledgor and the pledgee is therefore not entitled to cede the claims. The security by way of a pledge of claims will not automatically follow the principal debt into the hands of the cessionary. The SPV will have to enter into a new agreement with the pledgor if it wants to obtain the claims as security. However, it is possible for the pledgor to consent to the transfer of the security in the original agreement to pledge.

Furthermore, by analogy to a pledge of things a pledge of claims is an accessory form of security. This means that the security right will cease to exist when the principal debt is terminated. The effect of delegation on a pledge of claims will therefore be the same as in the case of mortgage, notarial bond and suretyship.

If the debtors of the claims used as security were informed of the original security cession, and the originator is not acting as servicer of the securitisation scheme, it will be necessary to inform the debtors to make payment to the actual servicer. Otherwise there is the risk that the debtors could continue to validly pay the originator.<sup>97</sup>

### 7.2.3.4 Instalment sale agreements

In terms of an instalment sale agreement the purchaser agrees with the seller to pay for the purchased thing in instalments over a determined period. The seller retains

<sup>96</sup> See par 5.4.3.2 for a detailed discussion of fiduciary security cession.

<sup>97</sup> See par 5.4.3.1 for a detailed discussion of pledge of claims.

ownership of the thing until full payment is received.<sup>98</sup> Vehicle financing agreements in South Africa are often instalment sale agreements.

The retention of ownership as security for the claim of the seller is not an accessory form of security. In other words, it is possible for the seller to cede his rights to receive payment to a third party, whilst retaining ownership in the sold things. The ownership will not fall away, as is the case when the principal debt of an accessory security right ceases to exist. Delegation therefore does not bring the seller's ownership to an end. However, usually the cessionary will want the security provided by the retention of ownership.

The cedent and the cessionary will have to enter into a new agreement to transfer the ownership in the thing to the cessionary. Ownership will not follow the claim automatically. All the requirements for the transfer of a real right, in this case ownership, will have to be complied with.<sup>99</sup> Of specific importance is the requirement that the thing must be delivered to the new owner. Most instalment sale agreements contain a clause to the effect that the purchaser will hold the sold item on behalf of the seller's cessionaries. It is my opinion that the purchaser will be held to such consent.<sup>100</sup>

However, there is a potential problem if the purchaser sells the thing and gives up control in favour of the new purchaser.<sup>101</sup> The new purchaser will not have entered into any agreement to hold the thing on behalf of the original owner and his cessionaries. There is case law to the effect that under these circumstances the original owner will not succeed in transferring ownership, because he will not be able to

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<sup>98</sup> The National Credit Act 34 of 2005 defines 'instalment agreement' as follows: "a sale of movable property in terms of which – (a) all or part of the price is deferred and is to be paid by periodic payments; (b) possession and use of the property is transferred to the consumer; (c) ownership of the property either – (i) passes to the consumer only when the agreement is fully complied with; or (ii) passes to the consumer immediately subject to a right of the credit provider to re-possess the property if the consumer fails to satisfy all of the consumer's financial obligations under the agreement; and (d) interest, fees or other charges are payable to the credit provider in respect of the agreement, or the amount that has been deferred."

<sup>99</sup> See par 7.2.3.

<sup>100</sup> See also *Caledon & SWD Eksekuteurskamer Bpk v Wentzel* 1972 (1) SA 270 (A) at 274H–275A, where the Court remarks in an *obiter dictum* that the purchaser would not be allowed to change his mind after initially consenting to possess the thing on behalf of the transferee. See further *Trust Bank van Afrika Bpk v Bitzer* 1978 (4) SA 115 (O) at 122H.

<sup>101</sup> The seller need not transfer ownership to the purchaser, but must only guarantee that no one with a stronger right will claim the thing from the purchaser, also referred to as the guarantee against eviction. See par 7.2.1 above. See also *ABSA Bank Ltd v Myburgh* 2001 (2) SA 462 (W) at 467F–G.

deliver the thing to the other party.<sup>102</sup> Under these circumstances it will not be possible for the SPV to gain ownership in the sold items. The SPV will take the claims against the purchasers without any security.

If ownership is transferred to the SPV, the SPV must accept the duty to transfer ownership to the purchaser by way of *traditio brevi manu* once full payment is received. The purchaser will have to consent to the transfer of such a duty,<sup>103</sup> but such consent can be given in the original instalment sale agreement. Furthermore, the real agreement reached when the thing is delivered to the purchaser is enough to let ownership pass to the purchaser on fulfilment of the condition that full payment must be received.<sup>104</sup> It is not necessary to enter into a new real agreement at the time when the final instalment is paid, nor is it necessary that a second form of delivery should take place at that time.<sup>105</sup> This is the case even when the instalment sale agreement is transferred.<sup>106</sup> The duty passed to the SPV to transfer ownership is therefore negligible.

#### 7.2.4 Transfer of future claims

In a securitisation of future claims the SPV issues securities supported by the likelihood that claims will be generated by the originator, whereafter the claims are ceded to the SPV.<sup>107</sup>

At present the leading case in South African law on the cession of future rights is *First National Bank of SA Ltd v Lynn NO*.<sup>108</sup> The facts of this case were briefly as follows. In 1984 the cedent, hereinafter referred to as the contractor, ceded to FNB

all our title and interest in and to all and any moneys and amounts which may now be or which may hereafter become due and owing to us by any person whomsoever as security for the fulfilment of all obligations undertaken by us to the bank ...

At issue was retention money owed to the contractor. The engineer, in terms of the construction contract between the contractor and the employer, issued a certificate of

<sup>102</sup> *ABSA Bank Ltd v Myburgh* 2001 (2) SA 462 (W) at 466B–C.

<sup>103</sup> See par 7.2.2.1. See also *Labuschagne v Denny* 1963 (3) SA 538 (A) at 544C–D.

<sup>104</sup> *Info Plus v Scheelke* 1998 (3) SA 184 (SCA) at 190I–J.

<sup>105</sup> *Info Plus v Scheelke* 1998 (3) SA 184 (SCA) at 191G–H.

<sup>106</sup> See the facts of *Info Plus v Scheelke* 1998 (3) SA 184 (SCA) at 187I–189A.

<sup>107</sup> *Reis-Roy* 1998 *J of Int Banking Law* at 299.

<sup>108</sup> 1996 (2) SA 339 (A).

completion on 27 August 1990. However, the payment of the retention money was subject to the completion of maintenance, which was only completed on 26 August 1991. The contractor was placed in provisional liquidation on 10 June 1991. At issue was whether the bank or the liquidators of the contractors were entitled to the payment of the retention money.

The minority judgment delivered by Joubert JA, Nestadt JA concurring, held that the claim to the retention money was a future right, which would only become a vested right on completion of the maintenance contract. Joubert JA accepts the construction of *De Wet and Van Wyk*<sup>109</sup> that although one may validly bind oneself to transfer a future claim when it comes into existence, it is not possible to enter into a transfer agreement before the claim comes into existence.<sup>110</sup> In terms of this interpretation, the contractor would have had to enter into a fresh transfer agreement when the claim came into existence. The agreement entered into in 1984 was not enough to affect the cession of the claim. The claim only came into existence after the date of the provisional liquidation order, which meant that the transfer agreement could not be entered into by the contractor. The retention money would then fall outside the security of the bank.<sup>111</sup>

The majority decision of the Court held that the right to the retention money became vested on the issuance of the certificate of completion on 27 August 1990, subject to the condition that the maintenance work will be carried out.<sup>112</sup> In their view, the claim was therefore vested before the date of the provisional liquidation. It is unclear from the judgment of Van den Heever JA, Van Coller AJA concurring, whether the Court considered the 1984 agreement enough to effect the cession of the claim when it came into existence, or whether the Court was of the opinion that the contractor entered into a valid transfer agreement after 27 August 1990. Van den

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<sup>109</sup> *Kontraktereg Sed* at 254: “Dit beteken egter nie dat mens ’n ‘vorderingsreg’, wat nog nie bestaan nie, maar wat in die toekoms mag ontstaan, of ’n vorderingsreg, waaroor ’n mens nog nie beskik nie, kan cedeer nie. Hiermee wil ek nie te kenne gee dat mens jou nie regsgeldig kan verbind om ’n vorderingsreg, wat jy in die toekoms mag verwerf, aan ’n ander oor te dra nie. So ’n ooreenkoms is wel geldig, maar dit maak die ander nog nie cessionaris nie. Hy word eers cessionaris indien die vorderingsreg, nadat dit ontstaan het of verwerf is, aan hom cedeer is.”

<sup>110</sup> At 346F–H.

<sup>111</sup> At 349F–H.

<sup>112</sup> At 535F and 357D.

Heever JA comes to the conclusion that the personal right was transferred to the bank before the liquidation<sup>113</sup> without dealing expressly with this question.

In this respect the judgment of Olivier JA is much clearer. The Court sets out two approaches to the possibility of a cession of future rights. According to the first approach,<sup>114</sup> parties may agree that they will transfer a future right when it comes into existence, but they cannot transfer the right before it is created. In other words, they would have to enter into the transfer agreement<sup>115</sup> after the right has come into existence.<sup>116</sup> It is not possible to enter into such an agreement beforehand, because there is no common law authority for the cession of a *spes*.<sup>117</sup>

In terms of the second approach, it is accepted that a future right cannot be transferred, nor can a *spes* in terms of the common law, but that as part of the legal and commercial reality in the country the transfer *in anticipando* of a *spes* is recognised.<sup>118</sup> Olivier JA lists a long line of cases in the Local and Provincial Divisions,<sup>119</sup> as well as in the Appellate Division,<sup>120</sup> that acknowledges the cession of future rights. The Appellate Division, now the Supreme Court of Appeal, will not easily depart from previous decisions which have been acted upon for some time.<sup>121</sup> He mentions specifically that the cession of book debts and factoring are dependant on the cedability of future rights.<sup>122</sup> Olivier JA prefers this second approach.<sup>123</sup>

<sup>113</sup> At 353F.

<sup>114</sup> Set out at 358A–G.

<sup>115</sup> Referred to by the Court (at 358B) as a 'real agreement'.

<sup>116</sup> At 358A–E.

<sup>117</sup> At 358F.

<sup>118</sup> At 358I.

<sup>119</sup> At 359B–D.

<sup>120</sup> *Waikiwi Shipping Co Ltd v Thomas Barlow and Sons (Natal) Ltd* 1978 (1) SA 671 (A) at 678A; *Bank of Lisbon and South Africa v The Master* 1987 (1) SA 276 (A) at 294H–I.

<sup>121</sup> *Holmes' Executor v Rawbone* 1954 (3) SA 703 (A) at 711E–F; *John Bell & Co Ltd v Esselen* 1954 (1) SA 147 (A) at 154B; *Cullinan v Noordkaaplansdse Aartappelkernmoerkwekers Koöperasie Bpk* 1972 (1) SA 761 (A) at 767H–768A; *Tuckers Land and Development Corporation (Pty) Ltd v Strydom* 1984 (1) SA 1 (A) at 16H–17D; *Rainbow Diamonds (Edms) Bpk v Suid-Afrikaanse Nasionale Lewensassuransiematskappy* 1984 (3) SA 1 (A) at 14I; *Du Plessis NO v Strauss* 1988 (2) SA 105 (A) at 141F–143C; *Ellispark Stadion Bpk v Minister van Justisie* 1990 (1) SA 1038 (A) at 1051F–H; *Willis Faber Enthoven (Pty) Ltd v Receiver of Revenue* 1992 (4) SA 202 (A) at 220E–G.

<sup>122</sup> At 359J.

<sup>123</sup> At 360A–B.

The position, in my view, then is that it has been accepted in commerce and by the Courts of our country for more than a century that future rights can be ceded and transferred *in anticipando*. The decisions of our Courts have thus been regarded for a very long period of time as being correct. Clearly these decisions have been acted upon and served as the basis for the general and well-known practice of taking security in the form of the cession of book debts (including future debts), cession of existing and future rights *in securitatem debiti* and factoring of existing and future rights. In these circumstances I am not inclined to hold that these decisions are wrong.

The Court then held that the right to claim payment of the retention money was transferred to the bank when it came into being on 27 August 1990.<sup>124</sup> The possibility of a cession of future rights *in anticipando* is therefore acknowledged by the Supreme Court of Appeal.

The Court does not attempt to provide an explanation of how and why such a cession would be possible. I submit that the exposition by Scott<sup>125</sup> of why the transfer of a future claim is possible, and the transfer of a future corporeal thing is not, makes sense. A corporeal thing can only be transferred after delivery, which is not possible before the thing is created. The method of transferring a future right facilitates the transfer of such rights *in anticipando*, because the transfer is done through an agreement. Scott then argues that if this agreement is the sole requirement for the cession, it is regarded as a completed juristic act and it cannot be dissolved unilaterally by one of the parties. The parties are bound by their expressions of will.

Since this construction of a cession of future rights was advanced by Scott, the Appellate Division, as it was then, confirmed in *Botha v Fick* that the agreement was the sole requirement for the transfer of the right during cession and that delivery of the document is not a substantive requirement.<sup>126</sup> In so doing the only obstacle to the applicability of Scott's construction was removed. However, this construction has not yet been expressly approved by the Supreme Court of Appeal.<sup>127</sup>

The difference between Scott's view and that of *De Wet and Van Wyk* set out above, is that in terms of the latter's view it is possible for the cedent to change his mind before the creation of the right. This is not possible in terms of Scott's

<sup>124</sup> At 360J–361A.

<sup>125</sup> *Cession* at 178. See also Scott 1997 *THRHR* at 648–649. For criticism of Scott's construction, see GF Lubbe "Die Oordrag van Toekomstige Regte" 1980 (43) *THRHR* at 129–131.

<sup>126</sup> *Botha v Fick* 1995 (2) SA 750 (A) at 778F–779B.

<sup>127</sup> In *First National Bank of South Africa v Lynn* 1996 (2) SA 339 (A) at 358E Olivier JA refers to Scott's view without commenting on it. It does, however, find favour with Nienaber in Joubert *et al LAWSA* at 15.

construction, since the parties are bound by their expressions of will.<sup>128</sup> This distinction is crucial to commercial practice in general, but to securitisation in particular, since the financier, and in this case the SPV, will want the certainty that the transfer of the claims will take place when they are created. From this perspective Scott's construction is therefore also to be favoured.

The Court in *First National Bank of South Africa v Lynn* is not clear on whether on materialisation the ceded right forms part of the estate of the cedent before transfer, or whether the claim is transferred to the estate of the cessionary directly. If the claim materialises in the estate of the cedent even for a moment during his insolvency, the claim will not be transferred to the cessionary, but will form part of the cedent's insolvent estate.<sup>129</sup> This was not relevant to the particular case, because the cession was one *in securitatem debiti*. The Court used the pledge of claims construction of cession *in securitatem debiti* to hold that although the claim was still part of the estate of the cedent, the bank was a secured creditor of the insolvent estate.<sup>130</sup>

For the claims to materialise in the estate of the cessionary, it must be possible to transfer an expectation (*spes*) of the materialisation of the right. There is no authority in South African law that a mere *spes* can be transferred<sup>131</sup> and this was confirmed in the *First National Bank of South Africa v Lynn* decision. Joubert's argument in favour of the adoption of such a possibility therefore seems not be in favour with South African courts.<sup>132</sup> This means that the claim will materialise in the estate of the cedent and will not pass if the cedent was in insolvent liquidation at that time.

I do not believe that securitisation will benefit much from the acceptance of the transferability of a *spes*. Where future claims are securitised the possibility of the non-materialisation of the future claims will be accounted for by the rating agencies and in the interest charged on the securities issued by the SPV. It must be accepted that the securitisation of such claims will carry more risk than would the securitisation of existing claims. In the event of the insolvency of the originator, the claims will not pass. The credit enhancements built into the securitisation scheme will take effect and

<sup>128</sup> See Scott *Cession* at 179.

<sup>129</sup> See Joubert *Kredietfaktorering* at 452. The SCA declined to decide this matter in *Smit v Carniasaad* 1998 (4) SA 877 (SCA) at 883E–F.

<sup>130</sup> At 361B–C. See also par 5.4.3 for a discussion of cession *in securitatem debiti*.

<sup>131</sup> See Lubbe 1980 *THRHR* at 128.

<sup>132</sup> Joubert *Kredietfaktorering* at 452–453.

the SPV will have a concurrent claim against the estate of the originator for the unperformed part of the transfer agreement.<sup>133</sup>

It is still uncertain whether the moment of transfer from an insolvency law point of view would be the date of the original cession agreement, or the date of the coming into being of the claim.<sup>134</sup> These dates become important when the transfer of the claims to the SPV is attacked as a voidable disposition by the liquidators of the originator.<sup>135</sup>

### 7.3 RELATIONSHIP BETWEEN SPV AND SERVICER

Securitisation Notice, 2008 defines ‘servicing agent’ as an “institution that acts as servicing agent in relation to the collection of the amounts due in terms of a traditional or synthetic securitisation scheme”.<sup>136</sup> The Notice further states that the retention of the servicing rights by the institution that transferred the assets to the special-purpose institution shall not constitute indirect control of the assets transferred.<sup>137</sup> In American law continued control by the originator over the transferred assets is an important factor when considering the true nature of the transaction between the originator and the SPV.<sup>138</sup>

However, Securitisation Notice, 2008 does not provide any further guidance on the relationship between the SPV and servicer. Although it uses the word ‘agent’, the Notice does not elaborate enough on the relationship between the SPV and the servicer to come to a definite conclusion that their relationship is exclusively one of agency. The legal relationship between the servicer and the SPV becomes especially important when the debtor is in default and the servicer wants to institute legal action against the debtor.

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<sup>133</sup> See also the comments of Susan Scott “Muller v Trust Bank of Africa Ltd 1981 2 SA 117 (N)” (1982) *De Jure* at 187.

<sup>134</sup> See also the comments of Scott *Cession* at 181. Also see the *obiter* comments of the Court in *Standard General Insurance Co Ltd v SA Brake CC* 1995 (3) SA 806 (A) at 815E.

<sup>135</sup> See par 8.2.

<sup>136</sup> Schedule, par 1. See also par 2.7 for the functions of a servicer generally. The Notice makes use of the term ‘collection’, but Susan Scott “Claim Enforcement (Debt Collection)” (2002) 14 *SA Merc LJ* 491 argues that this term may be construed as referring only to extra-judicial collection of claims. She therefore prefers ‘claim enforcement’, which encompasses the institution of legal proceedings to enforce claims.

<sup>137</sup> Schedule, par 4(2)(b)(iii).

<sup>138</sup> See par 4.3.2.1.



The nature of the relationship is determined with reference to the terms of the agreement between the servicer and the SPV. Depending on the terms of the agreement, the servicer may enforce the claims as representative of the SPV in the name of the SPV, or in its own name as cessionary for collecting purposes.<sup>139</sup> I shall also consider whether it is possible for the servicer to collect the claims in its own name, whilst acting as an agent for the SPV.<sup>140</sup>

Before discussing these concepts in turn, it must be mentioned that payment by the debtor can only be made to the creditor or to the creditor's duly authorised representative. Payment is a legal act in terms of which the debtor discharges his obligation towards the creditor. It consists of the handing over of money together with an agreement to extinguish the debt.<sup>141</sup>

Furthermore, it is necessary to distinguish between the concepts of 'mandate' and 'agency'. Mandate is a form of contract whereby the mandatary is obliged to carry out certain instructions on behalf of the mandator.<sup>142</sup> It is usual, but not necessary, that the mandatary is also an agent of the mandator. An agent is entitled, on behalf of his principal, to enter into, vary, or terminate a specified contractual relationship or contractual obligations of a specified class, or contracts generally. The obligations and contracts will be those of the principal and not those of the agent.<sup>143</sup>

Silke<sup>144</sup> draws attention to a further distinction between mandate and agency, namely that mandate mainly concerns the relationship between the mandator and the mandatary, whereas agency implies that a contractual relationship will be created between the principal and a third party with the agent as the intermediary.

In all three instances discussed below, the SPV (mandator) will enter into a contract of mandate with the servicer (mandatary) in terms of which the servicer will

<sup>139</sup> See Scott 2002 *SA Merc LJ* at 497.

<sup>140</sup> Referred to in German law as *Einziehungsermächtigung* and in Dutch law as *lasthebber ter incasso*. See Scott 2002 *SA Merc LJ* at 497.

<sup>141</sup> See Scott 2002 *SA Merc LJ* at 496.

<sup>142</sup> DJ Joubert & DH van Zyl "Mandate and Negotiorum Gestio" in WA Joubert *et al The Law of South Africa Vol 17* (1999) at 3; Kerr *Agency* at 12. See also Susan Scott "Regsfigure, Regsdogmatiek, Regsgeskiedenis, Regsvergelyking en die Bedoeling van Regsubjekte" in Eric Dirix, Walter Pintens, Patrick Senaev & Sophie Stijns *Liber Amicorum Jacques Herbots* (2002) at 359; Joubert *Kredietfaktoring* at 388–400.

<sup>143</sup> Kerr *Agency* at 4.

<sup>144</sup> Jonathan M Silke *De Villiers & MacIntosh: The Law of Agency in South Africa* 3 ed (1981) at 10–11.

be obliged to collect the debts due to the SPV.<sup>145</sup> In terms of section 20(7) of the Debt Collectors Act,<sup>146</sup> money collected by a debt collector and deposited in a separate trust account with a bank, as required by the Act, does not form part of the assets of the debt collector.<sup>147</sup> Regardless then of the form of the agreement between the SPV and the servicer, there is a measure of protection provided by the Act after the claims have been collected. However, the claims will form part of the assets of the servicer before collection, if the claims were ceded to the servicer for collecting purposes. If the servicer is declared insolvent after cession but before collection of these claims, the claims will form part of its estate and the SPV will only have a concurrent claim against the insolvent estate for the proceeds of the claim.

### 7.3.1 Servicer as representative of SPV

The agreement between the SPV and the servicer may provide that the servicer acts as an agent or representative of the SPV as principal. It acts in the name and on behalf of the principal and obtains no interest in the claims themselves.<sup>148</sup> There must be close co-operation between the representative and the principal for this arrangement to work efficiently.<sup>149</sup>

In the context of securitisation the debtor will usually not be notified that the claim against him has been transferred to the SPV. For purposes of extra-judicial debt collection, the SPV will grant the servicer the authority to collect the debts from the debtor. The servicer must account to the SPV for the money collected. Payment to the servicer as the duly authorised representative of the SPV will extinguish the debt owed by the debtor. Such payment terminates the debtor's obligation towards the SPV.

If the debt cannot be enforced extra-judicially and legal action must be instituted against the debtor, the servicer will have to institute proceedings on behalf of the SPV

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<sup>145</sup> Scott 2002 *SA Merc LJ* at 496. Other duties of the mandatary are to carry out the mandate, not to exceed the terms of the mandate, to perform the mandate personally, to act with reasonable care, to act in good faith, to render accounts and to account to the mandator after completion or termination of the mandate. The mandator has the duty to refund or compensate the mandatary for expenses or losses incurred during the execution of the mandate, and to pay the agreed remuneration to the mandatary. See Joubert & Van Zyl in Joubert *et al* *LAWSA* at 7–17.

<sup>146</sup> 144 of 1998.

<sup>147</sup> See the discussion in par 6.9.

<sup>148</sup> See *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 877H–I.

<sup>149</sup> Scott 2002 *SA Merc LJ* at 498.

as its principal.<sup>150</sup> The servicer is not the legal holder of the claims against the debtor and therefore has no standing on its own to institute proceedings. However, in *Hippo Quarries (TVL) (Pty) Ltd v Eardley* the Supreme Court of Appeal has expressed an *obiter* opinion that a mandate to collect claims on behalf of a principal and cession of the claims for collecting purposes may overlap and co-exist.<sup>151</sup> It will depend on the terms of the agreement between the SPV and the servicer whether such a cession was intended.<sup>152</sup>

### 7.3.2 Servicer as mandatary *in rem suam* of SPV

Initially, it was not possible in Roman law to cede a claim. However, the same result was achieved by giving a mandate to a person to institute proceedings as representative of a mandator to collect the mandator's claim from the debtor. The parties could further agree that the mandatary would collect the claim for his own benefit, in which case the mandatary was a *procurator in rem suam*. Roman law afforded the *procurator* several advantages, one of which was that the mandate to collect the claim did not lapse on the death of the mandator and could not be revoked by the mandator. It was also not possible for the debtor to pay the mandator after the debtor received notice of the mandate. Modern law of cession developed from the practice of the *procuratio in rem suam*.<sup>153</sup>

Most commentators of South African law of agency agree that an agreement whereby the mandatary receives payment from the debtor and may keep the proceeds for himself usually amounts to a cession of the claims and therefore falls outside the sphere of the principles of agency.<sup>154</sup> If the agreement between the parties does not amount to a cession of the claims, there is no reason why the consequences of the *procuratio in rem suam*, such as irrevocability, should follow automatically.<sup>155</sup>

<sup>150</sup> See also FR Malan *Collective Securities Depositories and the Transfer of Securities* (1983) at 205.

<sup>151</sup> *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 877I–878A.

<sup>152</sup> See the discussion below.

<sup>153</sup> See DJ Joubert *Die Suid-Afrikaanse Verteenwoordigingsreg* (1979) at 135; Scott *Cession* at 1.

<sup>154</sup> Joubert *Verteenwoordigingsreg* at 136; Silke *Agency* at 619–620; JC de Wet & BP Wanda “Agency and Representation” in WA Joubert *et al The Law of South Africa Vol 1 2* ed (2003) at par 199; Kerr *Agency* at 196 fn 62.

<sup>155</sup> Joubert *Verteenwoordigingsreg* at 136. The parties may agree that the mandate will be irrevocable *inter partes*. An example of this is where a mandate is granted to enable the mandatary to obtain security. Such a mandate is not revocable by the mandator while the debt to be secured remains unpaid. However, this mandate will come to an end with the insolvency of the mandator. See *Ward v Barrett* 1962 (4) SA 732 (N) at 737E–738B; Kerr *Agency* at 196–199; Silke *Agency* at 618.

Scott<sup>156</sup> argues that the *procuratio in rem suam* could still be used in South African law to achieve a similar result to the German institution of *Einziehungsermächtigung*.<sup>157</sup> In her opinion, this could especially be useful during fiduciary security cessions where no notice is given to the debtor of the cession. The cedent collects the claims, keeps the proceeds and cedes other claims to the cessionary in the collected claims' place. Since the cedent keeps the proceeds for himself he has an interest in the collection of the claims, even though the claims were ceded to the cessionary.

Under the circumstances set out above the cedent will collect the claims in his own interest. This interest will probably be enough to lead to a presumption of irrevocability *inter partes* of the mandate to collect, whereas some authors<sup>158</sup> are of the opinion that mere compensation for collection received by the cedent will not be a sufficient interest to lead to irrevocability of the mandate.

<sup>156</sup> In *Dirix et al Liber Amicorum* at 359–361.

<sup>157</sup> German law acknowledges the possibility of a mandator to instruct the mandatary to collect a claim in the name of the mandatary, while the claim itself remains in the estate of the mandator. *Einziehungsermächtigung* is not specifically provided for in the *Bürgerliches Gesetzbuch*, but evolved in legal practice and gained recognition by the German courts over time. *Einziehungsermächtigung* has become especially important for the proper functioning of fiduciary security cessions. During fiduciary security cessions the debtors are usually not informed of the cession, but continue to pay the cedent as if he were the holder of the claims. In reality, the claims were ceded to the cessionary and are no longer part of the estate of the cedent. However, the cessionary grants the cedent the power to collect the claims in his own name as if he were still the legal holder of the claims. The agreement between the cedent and the cessionary will determine what must happen to the proceeds, but often the cedent will keep the proceeds and replace the collected claim with another claim. If the debtor finds out about the cession, the cedent can continue with the proceedings through the procedural remedy of *gewillkürte Prozeßstandschaft*. In terms of this remedy it is possible for the legal holder of the claim to empower the mandatary to collect in his own name, but in the interests of the mandator, as long as the mandatary has an interest in the outcome of the proceedings. See in general Scott in *Dirix et al Liber Amicorum* at 351 *et seq*; Scott 2002 *SA Merc LJ* at 498–501; Malan *Collective Securities Depositories* at 205–206; Joubert *Kredietfaktorering* at 286–287.

<sup>158</sup> Joubert *Verteenwoordigingsreg* at 137: “Dit is duidelik dat nie elke finansiële belang van die gevolmagtigde by die uitvoering van die volmag as sodanig [onherroeplik] beskou kan word nie; die geleentheid om vergoeding te verdien, is byvoorbeeld geen sodanige belang nie.” [It is clear that not every financial interest of the agent in the exercise of the authority should be considered as such [irrevocable]; the opportunity to earn compensation is for example not such an interest.]; Silke *Agency* at 619–620: “... for any authority to be irrevocable, the authorized act must be one essentially, and not incidentally, for the benefit of the agent, so that ‘he can treat the transaction as his own, he shall be the dominating power, and anything requiring to be done in the matter shall be by his direction’ (*Van Niekerk v Van Noorden* 17 SC 63 at 66) ... the mere fact that one result of the granting of the mandate is that it, incidentally, gives the agent the chance of earning commission does not render it a mandate coupled with an interest ... and hence such mandate is not irrevocable.”

If the cedent can collect the claims judicially in his own name, he would do so as an agent for an undisclosed principal.<sup>159</sup> This would mean that the doctrine of the undisclosed principal is extended to procedural law.

The general rule in South African law is that an agent cannot sue personally for a debt due to his principal.<sup>160</sup> Exceptions are where<sup>161</sup>

- the contract purports to be a contract personally with the agent;
- the agent is the only known or ostensible principal;
- by the usage of trade or in the general course of business the agent is authorised to act as owner or as principal contracting party, although his character as agent is known;
- the agent has a special interest in the property, the subject matter of the contract, whether he professed at the time of concluding the contract to act as agent or not; and/or
- the contract contains a special stipulation that the agent may sue personally to enforce the contract.

Most of these exceptions rest on the premise that the agent entered into the contract giving rise to the claims that he now wants to enforce on behalf of the principal.<sup>162</sup> If

<sup>159</sup> Scott in *Dirix et al Liber Amicorum* at 360. De Wet & Wanda in Joubert *et al LAWSA* at par 221 describes the doctrine of the undisclosed principal as follows: "In English law ... direct *vincula iuris* can arise between an undisclosed principal, as he is called, and a third person from a contract concluded with the third person by another who contracts in his own name and not as representative. Although the third person and the person with whom he contracts contemplate the creation of *vincula iuris* between themselves, the undisclosed principal can emerge from obscurity and assert that he is the 'real' party to the contract and therefore entitled to the rights which arise out of it. Similarly, the third person, on discovering that there is an undisclosed principal lurking in the dark, can hold him liable." See also JC van der Horst *Die Leerstuk van die "Undisclosed Principal"* (1971) at 6.

<sup>160</sup> Louis de Villiers Van Winsen, Andries Charl Cilliers & Cheryl Loots *Herbstein and Van Winsen: The Civil Practice of the Supreme Court of South Africa* 4 ed (1997) at 131; Silke *Agency* at 592–593.

<sup>161</sup> *Commaille v Jamaloodien* 1917 CPD 656 at 659–660, accepting the view of Joseph Story *Commentaries on the Law of Agency as a Branch of Commercial and Maritime Jurisprudence: with Occasional Illustrations from Civil and Foreign Law* (1874) at par 393, and adding the ground of a special stipulation. See also *Continental Illinois National Bank and Trust Co of Chicago v Greek Seamen's Pension Fund* 1989 (2) SA 515 (D) at 538J–539B. Although this case followed the principles as set out in *Commaille*, it is distinguishable from most others because the respondent acted on behalf of the alleged principals in terms of legislation. This legislation was interpreted by the Court to include the right to enforce collection of contributions (at 541C) and the relationship between the respondent and the funds it represented were not truly one of principal and agent (at 541E).

the agent incurs liability on the contract, as is the case when he acts for an undisclosed principal,<sup>163</sup> he can usually also sue on the contract.<sup>164</sup> For many debt collectors this will not be true. They will be instructed to collect the debts after the debts have come into existence. However, the premise is true of the cedent who is given a mandate by the cessionary to collect the debts on the cessionary's behalf. Until the debtor is informed of the cession, the only person the debtor knows to be his creditor is the cedent. The cession will be valid even if the debtor is not informed.<sup>165</sup> This is also true for fiduciary security cessions.<sup>166</sup>

The majority of South African case law refuses to allow an agent to institute proceedings in his own name. In *Clark v Van Rensburg*<sup>167</sup> the Court accepted the possibility for a cedent to continue with an action in his own name but as the agent for the cessionary as undisclosed principal. The Court held that:<sup>168</sup>

Such a course is perfectly proper. It does not run counter to public interest and cannot prejudice the applicant in his capacity as contingent debtor of the cedent. He simply continues to deal with the cedent as his opponent and to look to his credit, such as it is, for any judgment or order for costs which may be granted to him by the Court. If the cessionaries are prepared to run the risk involved in such a course they should in my opinion not be obliged to disclose their existence to the debtor.

The Court held that it made no difference whether the cession took place before or after *litis contestatio*.<sup>169</sup> In *Waikiwi Shipping Co Ltd v Thomas Barlow and Sons (Natal) Ltd*<sup>170</sup> the Appellate Division, as it was then, held that a plaintiff could not transfer a right to prosecute action after *litis contestatio*, unless the Court sanctioned the transfer by a substitution of plaintiffs. If no application was made for substitution, the cedent remained the proper plaintiff and the cession only took effect between the cedent and the cessionary after the outcome of the litigation.<sup>171</sup> In an *obiter dictum* the

<sup>162</sup> *Story Agency* at par 393: "In all these cases the agent acquires personal rights and may maintain an action upon the contract in his own name without any distinction, whether his principal is or is not entitled also to similar rights and remedies on the same contract."

<sup>163</sup> See the discussion in n 159.

<sup>164</sup> *Silke Agency* at 594.

<sup>165</sup> See par 7.2.2.2.3 above.

<sup>166</sup> See par 5.4.3.2.

<sup>167</sup> 1964 (4) SA 153 (O) at 158H.

<sup>168</sup> At 158H–159A.

<sup>169</sup> At 160A–B.

<sup>170</sup> 1978 (1) SA 671 (A) at 678E–G.

<sup>171</sup> At 679A and 680A–B. The decision is criticised by Susan Scott "Effek van Sessie van Aksie na *Litis Contestatio*" 1978 *De Jure* 388 at 389 as based on an unsound interpretation of authority. The

Court expressed its doubt about the soundness of the extension of the doctrine of the undisclosed principal in contract law to procedural law, as was done in *Clark v Van Rensburg*.<sup>172</sup>

*Kotsopoulos v Bilardi*<sup>173</sup> concerned the cession of certain claims to the plaintiff in settlement of the cedent's indebtedness. The cession agreement provided that Walter Goldberg Trust Ltd was to be appointed the plaintiff's agent "irrevocably and *in rem suam*" to collect and distribute the money owing in terms of the ceded claims.<sup>174</sup> The plaintiff claimed the money owing in terms of the ceded claim. The defendant's second exception was on the basis that only Walter Goldberg Trust Ltd had *locus standi* to sue on the ceded claim.<sup>175</sup>

The Court held that a mandate to receive money from a debtor of the principal is only irrevocable in the sense that the agent may sue the principal for damages if the mandate is revoked.<sup>176</sup> If the mandate was not coupled with a cession of the right, the principal could revoke it and sue for the amount owing.<sup>177</sup> However, in the Court's opinion the facts under consideration amounted not only to a mandate to collect the money owing, but also to a cession by the plaintiff of the claims to Walter Goldberg Trust Ltd. Consequently, only Walter Goldberg Trust Ltd could sue and the exception was upheld.<sup>178</sup>

The *Kotsopolous* decision briefly referred to the possibility that in certain circumstances a cedent may enforce the ceded action in his own name, but as agent on behalf of the cessionary.<sup>179</sup> However, since the case was not decided on this basis the comment is only *obiter* and therefore not clear authority for the acceptance of the principle that an agent could sue in his own name.

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action should be freely transferable before and after *litis contestatio*, after which the cessionary ought to be substituted as plaintiff, unless such substitution will prejudice the debtor. Alternatively, the cedent can continue as empowered agent of the cessionary (at 390).

<sup>172</sup> At 680D–F.

<sup>173</sup> 1970 (2) SA 391 (C).

<sup>174</sup> See the terms of the agreement at 395G–H.

<sup>175</sup> At 398A–B.

<sup>176</sup> At 398D. On the issue of revocability generally, see n 158 above.

<sup>177</sup> At 398E.

<sup>178</sup> At 399A–B and 401G–402F.

<sup>179</sup> At 398H.

In *Sentrakoop Handelaars Bpk v Lourens*<sup>180</sup> the Court did not follow the *Clark* decision, holding that an agent could only sue on behalf of an undisclosed principal if the agent also contracted on behalf of the undisclosed principal.<sup>181</sup> The Court held that it was undesirable for an agent to sue in his own name on behalf of a principal.<sup>182</sup> The only reason the Court advanced for such undesirability was that it could create confusion as to who is responsible for costs.<sup>183</sup> However, as was referred to in the *Clark* decision quoted above, the cedent will be responsible for the costs and this should really not be a problem.<sup>184</sup>

*Standard General Insurance Co Ltd v Eli Lilly (SA) (Pty) Ltd (FBC Holdings (Pty) Ltd, Third Party)*<sup>185</sup> followed the reasoning in *Sentrakoop* and rejected the *Clarke* decision.<sup>186</sup> The Court consequently held that a plaintiff who ceded his claim before instituting action could not sue in his own name as agent for the cessionary.<sup>187</sup>

In *Myburgh v Walters NO*<sup>188</sup> the Court indicated that it preferred the *Sentrakoop* and *Eli Lilly* decisions to the decision in *Clarke*.<sup>189</sup> However, the *Myburgh* case was decided with reference to the wording of section 32(1)(b) of the Insolvency Act,<sup>190</sup> which only grants a *creditor* of an insolvent debtor the right to take proceedings in the name of the trustee if the latter fails to do so. On this basis the Court held that the person who instituted the proceedings must have a claim against the insolvent estate. In this case, it was not alleged that the agent was the holder of the claim. In fact, the claim vested in the trustee of the agent's insolvent estate and the agent therefore could not institute proceedings on the basis of section 32(1)(b).<sup>191</sup>

<sup>180</sup> 1991 (3) SA 540 (W). See also Belinda van Heerden "Legal Proceedings after Cession of Personal Rights: Some Perennial Problems" (1995) 112 *SALJ* at 382.

<sup>181</sup> At 543J. In *Myburgh v Walters NO* 2001 (2) SA 127 (C) at 130C–D the Court agrees with the view that the decision in *Clark* was premised on a misunderstanding of the law relating to the undisclosed principal.

<sup>182</sup> At 545A–B.

<sup>183</sup> At 545C.

<sup>184</sup> See further the comments of Scott in *Dirix et al Liber Amicorum* at 362–363.

<sup>185</sup> 1996 (1) SA 382 (W). See also the discussion of this case by Van Heerden 1995 *SALJ* at 379 *et seq.*

<sup>186</sup> At 386F–387C.

<sup>187</sup> At 387D.

<sup>188</sup> 2001 (2) SA 127 (C).

<sup>189</sup> At 130C–E.

<sup>190</sup> 24 of 1936.

<sup>191</sup> At 130F–131A. See also the comments of Scott in *Dirix et al Liber Amicorum* at 367.



*Grinrod (Pty) Ltd v Seaman*<sup>192</sup> followed the decision in *Eli Lilly* and held that after cession the cessionary is obliged to take steps to substitute itself as the new party to the litigation. The cedent cannot continue the case on the cessionary's behalf.<sup>193</sup>

From these cases it is clear that South African courts are generally sceptical about the possibility of an agent instituting proceedings in his own name on behalf of an undisclosed principal. Furthermore, the courts are not too keen on the extension of the doctrine of the undisclosed principal to other areas of the law. In *Cullinan v Noordkaaplandse Aartappelkernmoerkwekers Koöperasie Bpk*<sup>194</sup> the Appellate Division held that because the doctrine of the undisclosed principal is of questionable validity in South African law, its application should not be extended.<sup>195</sup>

### 7.3.2.1 Application to relationship between servicer and SPV

As South African law currently stands the courts are not in favour of allowing an agent to institute proceedings in his own name by extending the doctrine of the undisclosed principal to procedural law.<sup>196</sup> Even if in future the Supreme Court of Appeal holds that a *procuratio in rem suam* could still have application in our law beside the cession of a claim, it is doubtful whether the earning of a fee or commission would be a large enough interest to qualify the servicer as a *procurator*.<sup>197</sup>

I therefore submit that the servicer will have to take a cession of the claims for collecting purposes if it is to institute legal proceedings in its own name.

### 7.3.3 Servicer as cessionary for collecting purposes

A claim can be ceded for purposes of collection.<sup>198</sup> The cession is coupled with a fiduciary agreement<sup>199</sup> that the cessionary, who will collect payment in his own name,

<sup>192</sup> 1998 (2) SA 355 (C).

<sup>193</sup> At 354D–G.

<sup>194</sup> 1972 (1) SA 761 (A) at 770D–F. See also *De Wet & Wanda in Joubert et al LAWSA* at par 223.

<sup>195</sup> This view is shared by Van Heerden 1995 *SALJ* at 382. For a summary of the main points of criticism against the doctrine in South African law, see Van der Horst *Undisclosed Principal* at 107–114; *De Wet & Wanda in Joubert et al LAWSA* at par 223.

<sup>196</sup> See also Susan Scott “Object of Cession” 2000 *TSAR* at 777.

<sup>197</sup> See n 158.

<sup>198</sup> *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 875G; Scott 2002 *SA Merc LJ* at 501–503; *Malan Collective Securities Depositories* at 204–205. After the decision in *Skjelbreds Rederi A/S v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) some feared that cessions for collecting purposes would always be considered simulated (see David Dyzenhaus “Peregrines go Home” (1982) 99 *SALJ* at 540 and Nereus Joubert “*Plus Valet Quod Agitur Quam Quod Simulate*”

will account to the cedent for the proceeds so collected.<sup>200</sup> The cessionary claims as creditor of the claim and *locus standi* is therefore not at issue.

After the cession of the claim to the servicer, it is the creditor of the debtor. The legal position between the cessionary and the debtor is determined by the law of cession.<sup>201</sup> The mandate between the servicer and the SPV, in terms of which the servicer must account to the SPV for the proceeds collected, is of no concern to third parties. The claim will no longer form part of the SPV's estate. If the debtor has a claim against the servicer, the claim can be set-off against the claim payable in terms of the ceded debt.

The validity of a cession for collecting purposes has not often been considered by South African courts.<sup>202</sup> However, at least one decision of the Appellate Division, as it was then, held that a cession effected so that the cessionary could collect the debt for the ultimate benefit of the cedent, is valid. In *Hippo Quarries (TVL) (Pty) Ltd v Eardley*<sup>203</sup> the defendant entered into a suretyship agreement with the plaintiff. Owing to an administrative error, a fellow-subsiary of the plaintiff was the creditor of the claim that was to be secured by the suretyship. It was then agreed that the claim would be ceded to the plaintiff and that the plaintiff would proceed with recovering the debt from the defendant in terms of the suretyship agreement. The plaintiff would then account to the cedent for the money collected. The defendant argued that this transaction was simulated and that it was not the true intention between the parties to cede the claim.

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*Concipitur*: Toepassing op Sessie ter Invordering” 1983 TSAR at 80), but the validity of such cessions was subsequently affirmed by the Appellate Division in *Hippo Quarries*. See the discussion below.

<sup>199</sup> Cession for collecting purposes shares this fiduciary nature with fiduciary security cessions. Both forms of cession have the result that the claims will leave the estate of the cedent and form part of the estate of the cessionary, which leads to unsatisfactory results in the case of the insolvency of the cessionary. The cedent will then only have an unsecured claim against the estate of the cessionary. Scott 2002 SA Merc LJ at 521; 1997 THRHR at 434–444) therefore argues that South African insolvency law ought to be amended so that in the case of a fiduciary cession, whether for collecting purposes or for security, the claim reverts back to the estate of the cedent in the event of the cessionary's insolvency.

<sup>200</sup> Scott 2002 SA Merc LJ at 502.

<sup>201</sup> Scott 2002 SA Merc LJ at 508. See further the discussion in par 7.2.2.2.

<sup>202</sup> *McLachlan v Wienand* 1913 TPD 191; *Marsh v Van Vliet's Collection Agency* 1945 TPD 24; *Kotsopoulos v Bilardi* 1970 (2) SA 391 (C); *Goodgold Jewellery (Pty) Ltd v Brevadau CC* 1992 (4) SA 474 (W); *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A). See also Scott 2002 SA Merc LJ at 506 *et seq* for a discussion of these cases.

<sup>203</sup> 1992 (1) SA 867 (A).

The Court rejected an argument by the defendant that the cession should be held to be invalid because the plaintiff did not gain any direct benefit from it.<sup>204</sup> The defendant based this argument on a passage from *Kotsopoulos v Bilardi*.<sup>205</sup> The Court held that the *dictum* referred to by the defendant meant that the transaction would not be a cession if, according to its tenor, the right which the agent was to enforce did not vest in him. The cession was not assailable simply because the ultimate benefit will go to the cedent.<sup>206</sup>

The Court then considered whether the fact that the cession had the effect of converting an unsecured claim into a secured claim would, in the light of the decision in *Skjelbreds Rederi A/S v Hartless (Pty) Ltd*,<sup>207</sup> lead to a conclusion of simulation. The Court held that the matter in *Hippo Quarries* was distinguishable from that in *Skjelbreds Rederi*. In the latter case the aim was to circumvent a legal impediment or disability, namely to enable a *peregrinus* to attach the property of another *peregrinus ad fundandam jurisdictionem* when he is not entitled by law to do so.<sup>208</sup> In *Hippo Quarries* the impediment was one of fact rather than law, namely that the claim did not vest in the same person in whose favour the suretyship was granted.

The Court concluded its enquiry into the question of simulation with the following remarks:<sup>209</sup>

To cede the claim because the cessionary, for whatever legitimate reason, was better poised to collect it than the cedent was not intrinsically wrong. Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.

I discuss simulated transactions in South African law in more detail in the next section. However, for determining the legal relationship between the servicer and the SPV two principles can be drawn from the *Hippo Quarries* decision. First, this

<sup>204</sup> At 875E–F.

<sup>205</sup> 1970 (2) SA 391 (C) at 399A–C: “the hallmark of a mandate amounting to a cession is that it should give the agent an interest not merely in the exercise of his authority but in the very thing vested in, or entrusted to, him by his principal.”

<sup>206</sup> At 875G.

<sup>207</sup> 1982 (2) SA 710 (A). See also the discussion in par 7.4.1 below.

<sup>208</sup> At 876B.

<sup>209</sup> *Hippo Quarries (TVL) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 877D–E.

decision is authority that collection will be a valid *causa* for the cession of a claim in South African law.<sup>210</sup> Second, as long as the transaction reflects the true intention between the parties and does not aim to achieve a goal to which there is a legal bar, the court will give effect to the agreement and will not hold it to be a simulated act.

Where a person other than the originator acts as servicer to the securitisation scheme, the cession of the claims will always be a new cession unrelated to the initial cession of the claims from the originator to the SPV. Where the originator continues to act as servicer the claims can fall back to the originator by way of the fulfillment of the resolutive condition that the debtor defaults. Alternatively, the claims may be transferred by way of a new cession that bears no relation to the initial cession of the claims by the originator to the SPV. I submit that, bearing in mind the possibility of a future attack of the transaction as a simulation, it is preferable to formulate the cession as a new cession rather than as a resolutive condition in the sales agreement.

The resolutive condition in the original contract of sale will be to the effect that on default by the debtor that leads to the necessity of litigation to enforce the claim, the contract will be cancelled in respect of those individual claims by virtue of mutual agreement between the parties. This was referred to in *Johnson v Incorporated General Insurance Ltd*<sup>211</sup> as a resolutive agreement. There must also be a transfer agreement, which may be included in the resolutive agreement.<sup>212</sup>

In my opinion, there are two reasons why such a resolutive condition should be avoided. First, I submit that it might not comply with paragraph 4(2)(b)(ii) of Securitisation Notice, 2008, which prohibits any obligation on the side of the originator to retain the risk associated with the transferred assets. The resolutive condition will emanate from the original contract of sale and will essentially be an agreement to cancel on non-performance. This will in my opinion amount to an assumption of risk by the originator. Second, the assumption of risk may point towards a simulated intention between the parties.<sup>213</sup>

I therefore prefer that the cession to the servicer for collecting purposes must be contained in the servicing agreement. The agreement will be to the effect that under

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<sup>210</sup> For a more detailed discussion of this requirement in the context of collection of claims, see Scott 2002 *SA Merc LJ* at 503 *et seq*, and for cession generally, see Scott *Cession* at 79 *et seq* and 264.

<sup>211</sup> 1983 (1) 318 (A) at 332F–333A.

<sup>212</sup> See Scott *Cession* at 54–57.

<sup>213</sup> See the discussion below.

appropriate circumstances the servicer will inform the SPV of the need to institute legal action against the debtor. The service agreement will be the obligatory agreement. The service agreement may also contain the transfer agreement. The SPV must then see to it that the claims in question are ceded to the servicer for the purpose of collection. This could entail the co-operation of the trustee for debenture-holders, or the security SPV, if the claims were ceded by way of a fiduciary security cession in favour of the investors in the SPV. It is very important that the legal holder of the claim acts as the cedent, otherwise the claims cannot be validly ceded and the servicer will not have *locus standi* to institute the proceedings.

#### 7.4 SIMULATED TRANSACTIONS

One form of contract can achieve more than one economic result.<sup>214</sup> The economic result that an originator wants to achieve by means of a securitisation scheme is financing. The securitisation scheme effects this financing by way of a sales transaction of assets of the originator to the SPV. The scheme depends on the validity of this sale agreement and the transfer of the assets to the SPV. A 'true sale' legally removes the assets from the estate of the originator. These assets are insulated from the risk of a downturn in the business prospects of the originator and from the originator's insolvency. The insulation from the originator leads to a better credit rating than what a direct issue of securities by the originator could achieve. The higher rating leads to better interest rates. If it is successfully argued before a court that the transaction between the originator and the SPV was not a sale but rather a secured loan, the insulation from the originator will be lost and with it all the benefits of securitisation.

Certainly, the more traditional form of contract by which financing is obtained is one of loan. The question is to what extent the law allows parties to choose the form of contract that they want to use to achieve a specific lawful result.<sup>215</sup>

Generally, the characterisation of a contract is determined by whether a contract contains the essential elements of that particular contract.<sup>216</sup> The essential elements do not include the typical economic object of such contracts. It is therefore possible to

<sup>214</sup> Joubert *Kredietfaktorering* at 366; Joubert 1992 *SALJ* at 707.

<sup>215</sup> Joubert 1992 *SALJ* at 708.

<sup>216</sup> See par 7.2.1 for the essential elements of a contract of sale and par 7.4.2 for the essential elements of a contract of loan.

achieve more than one economic object with a particular contract and the same economic object by more than one form of contract.<sup>217</sup>

The parties involved in a securitisation scheme make no secret of the fact that they wish to put the transferred assets beyond the reach of the creditors of the originator. If the transaction between the originator and the SPV was one of loan and the assets served as security for that loan, the assets would remain in the estate of the originator if they were given in pledge. By selling and transferring the assets to the SPV the assets are permanently removed from the estate of the originator.

English courts give effect to the written contract between the parties, regardless of the economic outcome of the transaction. Most English authors agree that the risk of recharacterisation in English law is therefore very small.<sup>218</sup> The risk of recharacterisation is greater in the United States of America, because the characterisation of transactions is governed by state law where courts make such determinations by means of their equitable powers. Predominantly, courts make use of a scoring technique to determine whether a transaction is a sale or a loan. In other words, they look at how many attributes of a sale the transaction shows and compare that to the number of attributes of a loan the transaction shows to come to a conclusion.<sup>219</sup>

Despite concerns over recharacterisation in the United States of America, no securitisation transaction has yet been recharacterised and authors make use of case law relating to factoring to gauge the risk of recharacterisation for securitisation. The comparison with factoring makes sense, since factoring shares with securitisation the main ingredients of a possible recharacterisation:<sup>220</sup> both have financing as an economic objective and both are formulated as sale agreements when the more traditional transaction to achieve the financing goal would be a loan transaction. As in the United States of America, there has not yet been any recharacterisation of a securitisation transaction in South Africa.

The discussion below focuses on the approach of South African courts towards finding that a contract was simulated and then recharacterising the contract as the one

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<sup>217</sup> Joubert 1992 *SALJ* at 710.

<sup>218</sup> See par 3.3.2.3.

<sup>219</sup> See par 4.3.2.1.3.

<sup>220</sup> See par 2.9 for the distinction between factoring and securitisation.

which, in the court's opinion, was truly intended by the parties to the agreement. I pay specific attention to the risk of recharacterisation of factoring agreements.

#### 7.4.1 Simulated transactions in South African law

A simulated or disguised transaction was described as follows in *Commissioner of Customs and Excise v Randles, Brothers & Hudson, Ltd*:<sup>221</sup>

In essence it [a disguised transaction] is a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties ... before the Court can find that a transaction is in *fraudem legis* in the above sense,<sup>222</sup> it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible agreement is a pretence. The blurring of this distinction between an honest transaction devised to avoid the provisions of a statute and a transaction falling within the prohibitory or taxing provisions of a statute but disguised to make it appear as if it does not, gives rise to much of the confusion which sometimes appears to accompany attempts to apply the maxim quoted above.

The overriding principle is therefore that the true intention of the parties must be determined.<sup>223</sup> This implies that the court will not hold a contract to be simulated if the contract contains clauses not typically associated with that particular kind of contract, as long as the parties intended it to have those consequences. However, as Joubert correctly points out,<sup>224</sup> in practice it may become difficult to distinguish between the two instances set out by the Court in the *dictum* above. The courts tend to construe irregular clauses as showing simulation, especially if there is a sentiment that the transaction ought not to be allowed due to policy considerations.<sup>225</sup> Ultimately South African courts, just like the courts in the United States of America, tend to determine the true nature of a transaction by means of a 'checklist'.

Joubert suggests that the determination of whether a court should allow the avoidance of certain legal consequences by shaping a transaction in another legal form should be done in stages. First, the court should determine whether the

<sup>221</sup> 1941 AD 369 at 395–396. See further *Zandberg v Van Zyl* 1910 AD 302 at 309; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 611B–E; *Skjelbreds Rederi A/S v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at 732H–733E.

<sup>222</sup> A contract is in *fraudem legis* when it is designedly disguised so as to escape the provisions of the law, but in truth falls within these provisions. See *Dadoo v Krugersdorp Municipal Council* 1920 AD 530 at 547. It refers to a special application of the *plus valet* rule set out below and does not represent an independent rule of law. See Nereus L Joubert "Asset-based Financing, Contracts of Purchase and Sale, and Simulated Transactions" (1992) 109 *SALJ* at 711.

<sup>223</sup> Nienaber in Joubert *et al* *LAWSA* at 21.

<sup>224</sup> Joubert 1992 *SALJ* at 711.

<sup>225</sup> Joubert 1983 *TSAR* at 81; Joubert 1992 *SALJ* at 717–718.

transaction is lawful (*geoorloofd*), which incorporates concepts such as *boni mores* and the public interest.<sup>226</sup> Separately from this enquiry, the court should determine whether the contract between the parties complies with the essential elements of the contract that it purports to be.<sup>227</sup> If it does, the court should ask whether it is possible to reconcile the extraordinary elements of the contract with the essential elements. If this is possible, Joubert argues that the enquiry should stop there.<sup>228</sup> It should no longer be possible to argue that the extraordinary terms or objective of the contract shows that the parties did not intend to enter into the contract it purports to be.

If the court finds that the parties really intended a loan agreement rather than a sale, the contract will be regarded as a loan in terms of the maxim *plus valet quod agitur quam quod simulate concipitur*.<sup>229</sup> The following factors have been considered by the South African courts to be indicative of an intention to enter into a loan rather than a sale:<sup>230</sup>

- The wording of the written agreement will not be conclusive as to the intention of the parties, but terminology in the agreement that is more indicative of a loan agreement than of a sale will be taken into account.<sup>231</sup>
- Some decisions took into account the objective of the transaction as an indication of simulation.<sup>232</sup> However, the majority of decisions held that this was only one factor to consider,<sup>233</sup> or even that it ought not to be considered at all.<sup>234</sup>
- Several factual circumstances before and after the contract was entered into may show possible simulation. Examples of such circumstances include the continued

<sup>226</sup> Joubert *Kredietfaktorering* at 370–371.

<sup>227</sup> Joubert *Kredietfaktorering* at 372.

<sup>228</sup> See also Joubert 1992 *SALJ* at 717.

<sup>229</sup> Joubert *Kredietfaktorering* at 366.

<sup>230</sup> Joubert *Kredietfaktorering* at 373–380; Joubert 1992 *SALJ* at 712–715.

<sup>231</sup> *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 14; *Lawson and Kirk v South African Discount and Acceptance Corporation* 1938 CPD 273 at 285.

<sup>232</sup> Especially some of the older decisions such as *Zandberg v Van Zyl* 1910 AD 302 at 308; *Goldinger's Trustee v Whitelaw & Son* 1917 AD 66 at 76; *Bhaijee v Khoja* 1937 AD 246 at 250.

<sup>233</sup> *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 13; *Premier Finance Corporation v Rotainer* 1975 (1) SA 79 (W) at 82D–E.

<sup>234</sup> *Tucker v Ginsberg* 1962 (2) SA 58 (W) at 62F–G; *Engar v Omar Salem Essa Trust* 1970 (1) SA 77 (N) at 82H–83C; *Western Bank v Registrar of Financial Institutions* 1975 (4) SA 37 (T) at 45C–D and 53G–H; *Laztex v Telemetry Equipment* 1976 (1) SA 74 (W) at 76C.



collection of claims by the cedent,<sup>235</sup> the fact that a seller of a promissory note was held liable for the default of the drawer and that the buyer therefore did not assume any risk<sup>236</sup> and the fact that a buyer did not intend to make use of the purchased thing.<sup>237</sup> Reflecting the transaction as a sale in the seller's financial records will not lead to a conclusion that the parties intended a sale.<sup>238</sup> However, if the transaction is reflected as a loan in the seller's financial records it will be an indication of simulation.<sup>239</sup>

- When certain terms are found in a contract and those terms are usually not associated with that kind of contract, it is seen as a factor that points towards simulation.<sup>240</sup> The following terms are considered suspicious by South African courts when they appear in sale contracts:<sup>241</sup>
  - Although there is no legal requirement that the purchase price must be determined in a specific manner,<sup>242</sup> the purchase price is usually determined with reference to the market value of the sold asset. When the purchase price is determined with reference to other factors, such as the financing requirements of the seller, this may be seen as a factor that could indicate simulation.<sup>243</sup>

<sup>235</sup> *Lawson and Kirk v South African Discount and Acceptance Corporation* 1938 CPD 273 at 284.

<sup>236</sup> *Tucker v Ginsberg* 1962 (2) SA 58 (W) at 64D–G; *Laztex v Telemetry Equipment* 1976 (1) SA 74 (W) at 79D–H.

<sup>237</sup> *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 14; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 620G.

<sup>238</sup> *Lawson and Kirk v South African Discount and Acceptance Corporation* 1938 CPD 273 at 283.

<sup>239</sup> *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 386; *Bhaijee v Khoja* 1937 AD 246 at 253.

<sup>240</sup> *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 383–385, 400 and 404; *Zandberg v Van Zyl* 1910 AD 302 at 309, 311, 316 and 318; *Bhaijee v Khoja* 1937 AD 246 at 250; *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 14; *Liepner v Berman* 1944 WLD 16 at 21; *S v Dorfler* 1971 (4) SA 374 (RAD) at 377E–F.

<sup>241</sup> *Joubert Kredietfaktorering* at 378–380.

<sup>242</sup> *Joubert* 1992 SALJ at 714.

<sup>243</sup> *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 383; *Bhaijee v Khoja* 1937 AD 246 at 250; *Goldinger's Trustee v Whitelaw & Son* 1917 AD 66 at 77 and 93; *S v Dorfler* 1971 (4) SA 374 (RAD) at 378E; *MBE v Try Again Bus Company* 1975 (2) SA 156 (R) at 158B–C; *Lawson and Kirk v South African Discount and Acceptance Corporation* 1938 CPD 273 at 290; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 618A.

- Limitations on the buyer's entitlement to make use of and enjoy the purchased asset, or to dispose of it, are suspicious.<sup>244</sup> Such limitations are associated with pledge as a form of security, rather than with a sale.
- Terms that allow the seller to repurchase the asset in specified circumstances are regarded as suspicious, especially if there are other factors present that are also suspicious.<sup>245</sup> Usually, an asset given in pledge must be returned to the pledgor after he has paid the secured debt.
- It is considered suspicious in a purchase of claims when the seller guarantees that the debtor will perform.<sup>246</sup> This is only the case when the buyer looks primarily to the seller for performance on the claims and not, firstly, to the debtors.<sup>247</sup> Joubert<sup>248</sup> warns that factoring with recourse, coupled with the continued collecting of the claims by the seller, could lead to the recharacterisation of the transaction as a loan. Although the author does not specifically state in which capacity such collection by the seller must take place for suspicion to follow, I assume that it would be in the form of a resolute condition in the sale agreement or a cession for collecting purposes. If the seller collects as an agent for the buyer, it is essentially still the buyer who enforces that claim as principal.

#### 7.4.2 Application to securitisation

A creditor, or the originator's liquidator, may attempt to convince a court that the contract between the originator and the SPV was not a sale of claims, but a loan with the claims as security objects. The essential elements of a contract of sale were set out above.<sup>249</sup> The essential elements of a contract of loan are the following:<sup>250</sup>

<sup>244</sup> *Zandberg v Van Zyl* 1910 AD 302 at 309, 312 and 318; *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 382, 385, 400, 402 and 404; *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 14; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 616D–E.

<sup>245</sup> *Zandberg v Van Zyl* 1910 AD 302 at 311; *K & D Motors v Wessels* 1949 (1) SA 1 (A) at 14; *S v Dorfler* 1971 (4) SA 374 (RAD) at 377C–F; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 616G.

<sup>246</sup> *Moser v Meiering* 1931 OPD 74 at 78; *Tucker v Ginsberg* 1962 (2) SA 58 (W) at 64E; *Naidoo v Von Gerard and Chapman* 1931 AD 334 at 379; *New York Shipping v EMMI Equipment* 1968 (1) SA 355 (SWA) at 365G; *Laztex v Telemetry Equipment* 1976 (1) SA 74 (W) at 76D–G; *Lawson and Kirk v South African Discount and Acceptance Corporation* 1938 CPD 273 at 284.

<sup>247</sup> *Tucker v Ginsberg* 1962 (2) SA 58 (W) at 64H.

<sup>248</sup> Joubert *Kredietfaktorering* at 386–387.

<sup>249</sup> See par 7.2.1.

- The lender must give control of the asset and its use and enjoyment to the borrower.
- The borrower must undertake to give the same asset or similar assets back to the lender. 'Similar assets' in the context of money-lending will refer to legal tender as defined in the South African Reserve Bank Act.<sup>251</sup> Claims and promissory notes are not legal tender in terms of this definition. If the contract stipulates that in return for the money lending the lender must accept claims or promissory notes, this will *prima facie* not constitute a contract of loan but rather a contract of sale.<sup>252</sup>
- The borrower must be granted some time to use and enjoy the borrowed asset before being obliged to return it to the lender.

If the contract between the originator and the SPV was one of loan, it will be a money-lending transaction. The SPV will be the lender and the originator will be the borrower. On a first reading it seems as if the second of the essential elements of a loan contract will not be met during a typical securitisation transaction, because the originator and the SPV will agree from the start that the SPV will receive claims in return for money. However, this distinction is illusory.

Claims are turned into money the moment that the debtor performs in terms of the underlying agreement. If the originator continues to serve as servicer during a securitisation transaction, the originator will continually transfer the money received from the debtors to the SPV. Depending on the construction of their servicing agreement, the servicer/originator may also be the legal holder of the claims when they are ceded to it for purposes of judicial collection. This whole situation is aggravated if the servicer/originator undertakes to replace non-performing claims with similar claims, thereby undertaking the risk of non-performance of the claims. This creates the impression that the SPV is not truly exercising any of its entitlements to the claims, but only becomes involved after it has received the proceeds of the claims.

<sup>250</sup> Joubert *Kredietfaktorering* at 353–355. On the contract of loan in general, see DJ Joubert & JJ Henning "Loan" in WA Joubert *et al The Law of South Africa Vol 15 Part 2 2* ed (2008) at 172 *et seq.*

<sup>251</sup> 90 of 1989, s 17: gold coins and notes of the South African Reserve Bank up to any amount, coins of one rand or higher up to fifty rand, coins of ten cents up to and including fifty cents up to five rand, and coins of five cents or less up to fifty cents. See also Christie & McFarlane *Law of Contract* at 412; Kerr *Contract* at 523.

<sup>252</sup> Joubert *Kredietfaktorering* at 355.

Securitisation Notice, 2008 states that a bank or an institution within a banking group may *replace* at its own discretion one asset transferred in terms of a traditional securitisation scheme, with another one of equivalent credit quality.<sup>253</sup> The replacement of non-performing assets is specifically excluded from this provision. The Notice is silent on originators that are not banks and it therefore seems at first glance that they are free to arrange the replacement of assets as they please, without fear of non-compliance with the Notice.

One should further consider paragraph 4(2)(b)(ii) of the Notice, which provides that an originator shall be deemed to have maintained effective control over the transferred assets if the originator can *repurchase* the assets from the SPV in order to realise their benefits or is obliged to retain the risk relating to the transferred assets. This is a prohibited practice in terms of the Notice. The Notice draws a distinction between the *repurchase* of assets and the *replacement* of assets in that it allows the replacement of assets in certain circumstances. An originator is not allowed to take an asset back in return for a money payment, but may swap a previously transferred asset for another one of equal credit quality.

I submit that the provision relating to the repurchase of assets in the end amounts to the ability of the originator to assume the risk associated with the transferred asset, without that ability amounting to a duty. The first and second parts of paragraph 4(2)(b)(ii) therefore basically state the same rule. This rule is that an originator will be deemed to have maintained control over the transferred assets if it can, or is obliged, to assume the risk associated with the transferred asset.

Paragraph 4(2)(b)(ii) is binding on both bank and non-bank originators.<sup>254</sup> I therefore submit that although there is nothing in the Notice to prohibit a non-bank originator to replace a non-performing asset with another asset, such a provision in the obligatory agreement will amount to an ability or duty on the side of the originator to assume the risk associated with the asset. This will lead to a presumption that the originator has maintained control over the asset or assets, which is prohibited.

Control has been held to be an important indicator of a simulated transaction in the United States of America.<sup>255</sup> Risk assumption and control are also seen by Joubert<sup>256</sup> as

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<sup>253</sup> Schedule, par 4(2)(k).

<sup>254</sup> Schedule, par 2(1)(b)(i).

<sup>255</sup> See par 4.3.2.1.3.

major risks for the characterisation of factoring transactions as loan agreements rather than contracts of sale. I therefore submit that such provisions possibly could be considered by the courts as showing an intention between the parties that the originator should retain the risk and control over the assets when the debtors do not perform. Such a consequence is more akin to a loan agreement than one of sale and may be one of the factors that could sway a court to hold that a securitisation transaction was simulated.

However, in general, I submit that the risk of recharacterisation of a securitisation transaction, when measured against the factors that have emerged from case law on simulation, is limited:<sup>257</sup>

- The parties to the securitisation scheme truly intend to conclude a contract of sale and do their utmost to ensure that consequence. It is the only means by which they can achieve their ultimate economic objective,<sup>258</sup> namely to gain financing at a better interest rate than the originator could obtain without the insulation of the assets from its enterprise.
- Owing to the limiting provisions of Securitisation Notice, 2008, traditional securitisation schemes in South Africa are prohibited from making use of repurchase agreements during the transaction. As explained above,<sup>259</sup> I am of the opinion that this also applies to the replacement of non-performing claims by non-bank originators. Therefore the similarity that some previously recharacterised transactions showed with pledge does not apply to traditional securitisation transactions.

<sup>256</sup> Joubert *Kredietfaktorering* at 387 foresees the possibility of characterising factoring with recourse, where the client retains the debt collecting activities, as a loan agreement. In this situation the client retains the risk associated with the non-performance of the debtor on the transferred claim and also continues to control the administration of the collection of the claims.

<sup>257</sup> Joubert 1992 *SALJ* at 718–719 sets out the characteristics of transactions that have been found to be simulated. I use this as a basic point of reference.

<sup>258</sup> In *Skjelbreds Rederi A/S v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at 736A–B the Court held that the objective of the agreement between the parties, namely that the respondent as an *incola* would vest jurisdiction and institute proceedings against Skjelbreds, indicated simulation. This was criticised by Dyzenhaus 1982 *SALJ* at 544 and Joubert 1983 *TSAR* at 79, because the only means by which the parties could achieve their objective was by way of cession. Rather than indicating simulation, this fact shows that the parties truly intended to effect a cession. See also Scott *Cession* at 264. See further *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 at 403 with reference to the disputed transfer of ownership of material: “It was so much in their [the parties’] interests to have the intention of transferring ownership that it is difficult to believe that they did not have it.”

<sup>259</sup> See n 253 and 254.

- Securitisation does not have the effect of converting a previously unsecured debt into a secured debt, thereby affecting the interests of other creditors. It can therefore be distinguished from cases such as *Zandberg v Van Zyl*<sup>260</sup> and *Vasco Dry Cleaners v Twycross*.<sup>261</sup>
- In most of the case law that allowed for the recharacterisation of the assets transferred in terms of the purported sale, the assets were movable corporeals and not claims. Furthermore, the seller mostly remained in control of the transferred assets.<sup>262</sup> The policy consideration behind finding such transactions simulated, lies in the lack of publicity of the transfer of ownership in terms of the sale. It is argued that the creditors of the purported seller are potentially prejudiced, because they have no way of knowing that the assets no longer fall in the estate of the seller when they extend credit to him. I submit that the same argument cannot be made out in the case of securitisation. First, the estate of the originator is not impoverished by the sale of the assets to the SPV. The originator is paid for the transfer of the claims to the SPV, so that one asset (the claim) is simply replaced by another (money). Second, in South African law there is no physical manner, comparable to delivery or registration of corporeal things, in which to publicise the transfer of claims to third parties. It is therefore doubtful whether the transfer of claims during securitisation could be questioned on this basis.
- The SPV becomes the legal holder of the claims without restriction. Cession for collecting purposes ought not to be drafted as a resolutive condition in the contract of sale, but must be formulated and administered within the service agreement between the SPV and servicer, and possibly the security SPV. As such, it should stand apart from the original transfer of the claims and should not be a factor during a consideration of the characterisation.

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<sup>260</sup> 1910 AD 302. Ms van Zyl owed Zandberg, her son-in-law, £50. After some time, he demanded payment from her, but she could not pay him. She then offered her wagon as payment. He accepted the wagon as payment, but the wagon remained in Ms van Zyl's control. The parties further agreed that Ms van Zyl could repurchase the wagon at any time when she required it. It was argued that this agreement was rather one of pledge than of sale.

<sup>261</sup> 1979 (1) SA 603 (A). C sold the dry cleaning business to A C (Pty) Ltd. The passing of ownership of the cleaning machinery was suspended until the full purchase price was paid. A C (Pty) Ltd and T later agreed that T will pay the outstanding balance and that ownership of the cleaning machinery would pass to T. T would then sell the machinery to A C (Pty) Ltd at the same price, as long as payment was received before a specified date. The business, including the machinery, was sold to the appellant, who argued before the Court that the nature of the agreement between T and A C (Pty) Ltd was a pledge rather than a sale.

<sup>262</sup> See for instance *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A).

- The SPV intends to become owner and to make use of the transferred claims by using them as security for the issuing of debt securities. The SPV may even transfer the claims to the security SPV if it decides to make use of a fiduciary security cession. It can therefore not be said that the SPV does not intend to make use of the transferred claims.

## 7.5 CONCLUSION

There are two necessary agreements between the originator and the SPV to transfer the claims to the SPV. The first is an obligatory agreement in the form of a contract of sale.<sup>263</sup> The second is the transfer agreement. The contract of sale provides the *justa causa* for the transfer agreement.<sup>264</sup> Owing to the operation of the abstract system of the transfer of rights in South African law, the invalidity of the contract of sale will not affect the transfer of the claims to the SPV. Should the SPV be declared insolvent under such circumstances, the investors will have secured claims against the insolvent estate of the SPV, whereas the originator will have a concurrent claim against the insolvent estate based on unjust enrichment.

The transfer agreement between the originator and the SPV can either take the form of delegation or of cession. Although delegation is the form implied by Securitisation Notice, 2008,<sup>265</sup> I submit that cession lends itself much better to the objectives of a traditional securitisation scheme.

The reasons why I prefer cession to delegation are the following:<sup>266</sup>

- The debtor must not only be informed of the transfer during delegation, but must also give his consent for the substitution of his debtor for another party. If the original agreement was in writing and contained a standard non-variation clause, the written agreement will have to be substituted for a new one. This has administrative, time-delay and cost implications.
- Delegation is a form of novation, which means that the original claims are terminated and replaced by the new agreement. Owing to the accessory nature of

<sup>263</sup> See par 7.2.1.

<sup>264</sup> See pars 7.2.2 and 7.2.2.2.2.

<sup>265</sup> Schedule, par 4(2)(a).

<sup>266</sup> See par 7.2.2.1.

real security rights and suretyship, these rights will terminate along with the claims.

- The SPV may be unable to perform the duties transferred to it, because of the limitations stated in its objects clause.
- The duties transferred to the SPV may render the SPV vulnerable to insolvency, because it is not supposed to engage in business outside of the securitisation scheme. An example is the securitisation of operating leases of equipment. Such leases usually entail that the lessor, which will be the SPV after transfer, remains responsible for maintenance of the equipment.
- The use of covering bonds during securitisation sheds particular light on the problems associated with the transfer of duties to the SPV.<sup>267</sup> I conclude that the requirements of the Deeds Registries Act<sup>268</sup> and Securitisation Notice, 2008 lead to the situation that both the rights and duties between the originator and the debtor will have to be transferred to the SPV to register a valid cession of the covering bond. The SPV will usually not meet the capital requirements of a credit provider. Ideally, it should be possible for the originator to remain responsible for the duties towards the debtor and to only cede the claims against the debtor to the SPV.

The peremptory language used in Securitisation Notice, 2008 to require that both rights and duties must be transferred to the SPV, thereby implying that the transfer of the assets must be in the form of delegation, is unfortunate. It ought to be possible for an originator to transfer the claims arising from the underlying transactions, but to remain liable for any outstanding duties, and to still qualify for the exemption provided for by the Notice. The current wording of the Notice suggests that cession alone will only be acceptable for the transfer of the assets to the SPV when the originator owes no further duties to the debtor. This does not serve the aims of the originator, who wants to acquire financing whilst maintaining a business relationship with its debtors.

There are few obstacles in the South African law of cession to its use during securitisation. However, if ever the legislature decides to codify the law of cession

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<sup>267</sup> See par 7.2.3.1.

<sup>268</sup> 47 of 1937.



due consideration should be given to the use of cession to transfer claims during securitisation.

Cession is effected in South African law through agreement alone. Delivery of the document that evidences a claim is not a requirement for the cession of such a claim.<sup>269</sup> This is the case also if the transferred assets are securities. The parties to a transfer of securities can agree that the seller will remain the registered holder of the securities. In such a case the seller must inform the company every three months of the persons on behalf of whom he holds securities.<sup>270</sup> The beneficial owners of securities are also listed in a register, which is open for public inspection. It cannot be argued that third parties are harmed by non-registration of the interests of a beneficial owner. If the parties agree that the purchaser must be registered as holder of the securities, but for whatever reason the formalities for such registration have not been complied with, the court in my opinion has the discretion in terms of section 115(3) of the Companies Act<sup>271</sup> to order the rectification of the register.

Notice to the debtor is not a requirement for cession in South African law, but before the debtor receives notice he may discharge his duty by payment to the cedent.<sup>272</sup> This must be kept in mind if the originator does not act as servicer after the securitisation.

The potential of set-off of the claims of the debtor against the transferred claims,<sup>273</sup> as well as possible defences that the debtor may raise,<sup>274</sup> must be kept in mind during the structuring phase of the securitisation scheme. Appropriate credit enhancement must be put in place to address the possibility of set-off and defences.

Since delegation is implied by Securitisation Notice, 2008 as the transfer agreement, it must be concluded that all accessory security rights held by the originator before transfer of the claims to the SPV cease to exist on transfer. I briefly considered the requirements for the transfer of security rights when the claims they secure are transferred to the SPV by means of cession. Provided that the requirements for the transfer of real rights are met, the transfer of mortgages and special notarial

<sup>269</sup> See par 7.2.2.2.1.

<sup>270</sup> Section 140A of the Companies Act 61 of 1973.

<sup>271</sup> 61 of 1973.

<sup>272</sup> See par 7.2.2.2.3.

<sup>273</sup> See par 7.2.2.2.4.

<sup>274</sup> See par 7.2.2.2.5.

bonds that secure the transferred claims ought not to pose major problems during securitisation.<sup>275</sup> Suretyship follows the transferred claim automatically, unless specifically excluded.<sup>276</sup> Consent of the pledgor is required for a transfer of claims given in a pledge of claims.<sup>277</sup> However, the consequences of a transfer of covering bonds, where the originator continues its relationship with the debtors, are less certain.<sup>278</sup>

The registration of the transfer of the covering bond envisaged in section 52 seems to me to indicate a transfer of claims and duties, since it makes provision for future advances. As was set out in the list above, the SPV is not suited for the performance of duties outside the securitisation scheme. The splitting of the covering bond in favour of two creditors is not allowed by the Deeds Registries Act<sup>279</sup> and, in my opinion, it should not be allowed for policy reasons. A splitting will increase the burden of the debtor, which he would not have foreseen if he consented to a transfer of the bond in the original agreement.

The solution to the problems surrounding covering bonds is that Securitisation Notice, 2008, should be amended so that it is possible to only cede claims to the SPV and not the duties that arise under an agreement. In such an event the originator could continue its relationship with its client. One of two options could then be employed with regard to the covering bond. The covering bond could remain with the originator and the claims as they result from the credit relationship could be ceded to the SPV. These claims will then be unsecured after transfer to the SPV. Otherwise, the originator could transfer the covering bond to the SPV and cede the claims to the SPV as they arise. The originator will no longer be secured by the bond, but the risk associated with the claims against the debtor is substantially less due to the securitisation. The bond itself will still cover the claims it was intended for up to the maximum as stated in terms of the requirements of the Deed Registries Act.<sup>280</sup>

For the transfer of non-accessory forms of security, such as fiduciary security cession of claims and retention of ownership in instalment sale agreements, a separate

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<sup>275</sup> See par 7.2.3.

<sup>276</sup> See par 7.2.3.2.

<sup>277</sup> See par 7.2.3.3.

<sup>278</sup> See par 7.2.3.1.

<sup>279</sup> 47 of 1937, s 50(5).

<sup>280</sup> Section 51.

agreement to transfer the security to the SPV is also needed. In such cases the originator will be entitled to transfer.<sup>281</sup>

The transfer of future claims is possible in South African law, but the basis of the recognition of such a possibility has not yet been set out by the Supreme Court of Appeal.<sup>282</sup> I agree with Scott's argument that the distinction lies in the fact that claims are not material and that their transfer is affected by agreement alone. Such an agreement is regarded as a completed juristic act and it cannot be dissolved unilaterally by one of the parties. The parties are bound by their expressions of will.

It remains unclear in South African law whether future claims first materialise in the estate of the cedent or whether they materialise in the estate of the cessionary directly. If the claims materialise in the estate of the cedent first, they will not pass to the cessionary if the cedent is insolvent at that stage. I argued that this should not pose too much of a problem to securitisation in South Africa, since the securitisation of future claims will always be more risky. The scheme will therefore make provision in its structure for the fact that the financial soundness of the originator still has some influence on the stability of the scheme.

I considered the relationship between the SPV and the servicer in depth.<sup>283</sup> The SPV (mandator) will enter into a contract of mandate with the servicer (mandatary) in terms of which the servicer will be obliged to collect the debts due to the SPV. The agreement between the SPV and the servicer will determine whether this mandate will result in agency, a mandate *in rem suam* or a cession for collecting purposes.

If the servicer acts as an agent of the SPV, it can collect claims on behalf of the SPV extra-judicially without informing the debtor of the cession of the claims. However, when the claims are collected judicially the originator will have to act on behalf of the SPV as its agent; otherwise the SPV will have no standing.<sup>284</sup>

I considered whether it is possible for the servicer to institute proceedings in his own name on behalf of the SPV. The servicer will then act on behalf of an undisclosed principal.<sup>285</sup> This will only be possible where the servicer was the originator of the scheme, because the doctrine only has application where the debtor

<sup>281</sup> See pars 7.2.3.3 and 7.2.3.4.

<sup>282</sup> See par 7.2.4.

<sup>283</sup> See par 7.3.

<sup>284</sup> See par 7.3.1.

<sup>285</sup> See par 7.3.2.

contracted with the agent only and was unaware of the principal. If the servicer is a third party, the debtor will of necessity be informed of the securitisation and of his new creditor.

A review of case law shows that South African courts are generally opposed to the possibility of allowing an agent to sue in his own name. The courts are also opposed to extending the doctrine of the undisclosed principal to other areas of the law, such as procedural law. It is therefore safer to cede the claims to the servicer for collecting purposes, if the servicer is to collect the claims in its own name.

If the servicer is not the originator of the scheme, the cession for collecting purposes is a new cession unrelated to the initial transfer of the claims to the SPV.<sup>286</sup> If the servicer was also the originator of the scheme, there are two possibilities. First, the cession could flow from a resolutive condition in the transfer agreement to the effect that on default by the debtor the transfer will be ineffective in respect of those individual claims by virtue of mutual agreement between the parties. Alternatively, the cession can be in terms of a clause in the servicing agreement to the effect that the claims will be ceded to the servicer when it needs to collect the claims judicially.

There are two reasons why I am not in favour of a resolutive condition to provide the servicer with *locus standi* to collect the claims. It might not comply with paragraph 4(2)(b)(ii) of Securitisation Notice, 2008, which prohibits any duty on the side of the originator to retain the risk associated with the transferred assets. Second, the assumption of risk by the originator that acts as servicer creates the impression that the transfer of the claims was not in execution of a true sale.

Where the cession is a fresh cession for collecting purposes, the agreement to cede will be contained in the servicing agreement. The agreement will provide that under appropriate circumstances the servicer will inform the SPV of the need to institute legal action against the debtor, after which the SPV will cede the claims to the servicer for collecting purposes. The servicing agreement will be the obligatory agreement and the *causa* of the cession will be to collect the debt. The same agreement may contain the transfer agreement. The co-operation of the security SPV will be necessary to cede the claims to the servicer where the claims were given as security to the security SPV by way of a fiduciary security cession.

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<sup>286</sup> See par 7.3.3.

After an analysis of the position in South African law on simulated transactions,<sup>287</sup> I conclude that the risk of recharacterisation of the transfer of the assets to the SPV as a loan is small.<sup>288</sup> The following factors lead me to this conclusion:

- The parties to the securitisation scheme truly intend to conclude a contract of sale and do their utmost to ensure that consequence. It is the only means by which they can achieve their ultimate economic objective, namely to gain financing at a better interest rate than the originator could obtain without the insulation of the assets from its enterprise.
- Owing to the limiting provisions of Securitisation Notice, 2008, traditional securitisation schemes in South Africa are prohibited from making use of repurchase agreements during the transaction. Bank originators may not replace non-performing assets with other similar, but performing assets. I am of the opinion that this also applies to the replacement of non-performing claims by non-bank originators, because it would mean that they retain some of the risk associated with the asset.
- Securitisation does not have the effect of converting a previously unsecured debt into a secured debt.
- In most of the case law that allowed for the recharacterisation of the assets transferred in terms of a purported sale, the assets were movable corporeals and not claims. Furthermore, the seller mostly remained in control of the transferred assets. The policy consideration behind finding such transactions simulated, lies in the lack of publicity of the transfer of ownership in terms of the sale. It is argued that the creditors of the purported seller are potentially prejudiced, because they have no way of knowing that the assets no longer fall in the estate of the seller when they extend credit to him. I conclude that the same argument cannot be raised in the case of securitisation. The originator is not impoverished by the sale of the assets to the SPV. The originator is paid for the transfer of the claims to the SPV, so that one asset (the claim) is replaced by another (money). Furthermore, claims are transferred by agreement alone and not publicised by delivery as is the case with corporeal movable property.

<sup>287</sup> See pars 7.4 and 7.4.1.

<sup>288</sup> See par 7.4.2.

- The SPV becomes the legal holder of the claims (owner) without restriction. As explained above, cession for collecting purposes to the originator/servicer should be provided for in the servicing agreement and not through a resolutive condition in the contract of sale.
- The SPV as owner intends to make use of the transferred claims by using them as security for the issuing of debt securities. The SPV may even transfer the claims to the security SPV if it decides to make use of fiduciary security cession. It can therefore not be said that the SPV does not intend to make use of the transferred claims.

## CHAPTER 8 INSOLVENCY LAW CONSIDERATIONS IN SECURITISATION

### 8.1 INTRODUCTION

Insolvency legislation and the ability of the securitisation scheme to withstand the insolvency of the originator and other participants in the scheme are key considerations in the rating of a securitisation scheme.<sup>1</sup> They also influence the structuring of the scheme. In a study carried out by Standard & Poor's the following aspects of the insolvency legislation and practice of countries were identified as important to determine the credit rating of a securitisation scheme:<sup>2</sup>

- The availability of assets across the corporate group to secured creditors. In other words, whether there are restrictions on the granting of security by a holding company to its subsidiaries, by subsidiaries to the holding company and by fellow subsidiaries to one another. Of specific importance here is whether related companies may provide guarantees as credit enhancements and this aspect falls outside the scope of this study.
- The process of creating security over assets of a company. This includes whether it is possible to create security over most of the company's assets, the process of perfection of security, the cost and effectiveness of the perfection process and preference periods specified in insolvency legislation to set aside security.<sup>3</sup>
- The extent to which secured creditors can commence and/or control insolvency proceedings.
- The strength of the protection available to secured creditors when they exercise their security rights. This includes enquiries into the permitted realisation routes and how long it takes to realise assets.

Securitisation Notice, 2008 defines 'insolvency-remote' in respect of an SPV as that the assets of that SPV shall not be subject to any claim by an institution transferring assets in terms of a traditional securitisation scheme to the SPV as a result of the

<sup>1</sup> Report by Standard & Poor's "Bridging the Insolvency Gap in European Securitization." 30 September 2003 available at [www.ratingsdirect.com](http://www.ratingsdirect.com); Report by Fitch Ratings *Special-Purpose Vehicles* at 5–6.

<sup>2</sup> Standard & Poor's *Bridging the Insolvency Gap*.

<sup>3</sup> I consider these aspects in ch 5 and in par 8.2.

transferring institution's insolvency.<sup>4</sup> In other words, an SPV is insolvency-remote from its originator when the assets transferred to the SPV from the originator cannot be reclaimed in any manner from the SPV should the originator subsequently go into insolvent liquidation.

The rest of Securitisation Notice, 2008 does not mention insolvency-remoteness specifically, but I submit that the concept of insolvency-remoteness is so closely linked with the requirement of a true sale of the assets to the SPV that the inclusion of its definition in the Notice is necessary and helpful. The difficulty in distinguishing between the concepts of a true sale and insolvency-remoteness is illustrated in paragraph 4(2)(b) of the Notice. Paragraph 4(2) generally deals with the limitation of the originator's association with the transferred assets in order to comply with the true sale requirement.<sup>5</sup> However, subparagraph (b) extends to insolvency-remoteness, where it states that

... the assets shall be legally isolated from the institution that transferred the assets in such a way that the assets and the benefits that relate to the assets shall be placed beyond the reach of the institution that transferred the assets, and its creditors, even in the event of bankruptcy or liquidation ...

The Notice obliges banks and institutions within a banking group to obtain an opinion from an independent qualified legal counsel that the true sale requirements of the Notice, as well as insolvency-remoteness as defined in the quoted paragraph, have been met. This requirement is peremptory, which means that failure to obtain such an opinion will be non-compliance with the Notice and the consequences that go with such non-compliance will follow.<sup>6</sup> Independent legal opinion on the true sale requirement and insolvency-remoteness is not a requirement for non-bank originators, but is advisable. It will show the intent on the part of the originator and SPV to comply with the requirements of the Notice.

The provisions of Chapter VIII of the Banks Act<sup>7</sup> as discussed in paragraph 6.3.1 must be kept in mind during the course of this chapter. If the SPV did not comply with the provisions of Securitisation Notice, 2008, and becomes subject to

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<sup>4</sup> GN 2, GG 30628 (1 January 2008) Notice on Banks Act 94 of 1990 – Designation of an Activity not Falling within the Meaning of 'The Business of a Bank' (Securitisation Schemes), Schedule, par 1.

<sup>5</sup> The provisions of Securitisation Notice, 2008, that deal with the true sale requirement are discussed in ch 7.

<sup>6</sup> See par 6.3.

<sup>7</sup> 94 of 1990.



Chapter VIII, the Registrar of Banks is granted certain special powers. He may oppose any application for the winding-up of the SPV by the SPV or by any other person. He may further apply for the winding-up of the SPV and if the application is successful, the Master must appoint the liquidator preferred by the Registrar.

If the liquidator of an insolvent originator is successful in impeaching the transfer of the assets to the SPV, the SPV will have failed to comply with the true sale and insolvency-remoteness requirements of the Notice. As a result, the above-mentioned provisions of Chapter VIII will take effect. In other words, the insolvency of the originator is not supposed to have any effect on the position of the SPV. However, in the unlikely event that the insolvency of the originator does affect the SPV, as set out below, the provisions of Chapter VIII of the Banks Act will take effect.

It is important to note that the insolvency-remoteness of the SPV does not mean that the SPV is insolvency-proof.<sup>8</sup> Even when all the considerations discussed in this chapter are addressed, there may be isolated cases where the transfer of the assets can be avoided by the liquidator of an insolvent originator. Also, while every effort is made during the structuring of a securitisation scheme to ensure that the SPV itself bears little risk of insolvency,<sup>9</sup> extreme situations of default on the principal debts as a result of an economic slump cannot be prevented by the structuring of the scheme and may lead to the SPV's inability to meet its duties in terms of the issued securities.

The first possible method, by which the transfer of the assets to the SPV may be disputed, is by way of a claim by the liquidator of the insolvent originator that the transfer of the assets was not a true sale, but, in fact, amounted only to a secured loan. The possibility that the transaction could be held to be a simulated transaction in South African law was discussed in the previous chapter.

The possible risks that insolvency law may hold for the avoidance of the transfer of the assets to the SPV are still untested by South African courts. I therefore rely on precedent not discussing securitisation particularly, but stating wider principles of the application of the provisions of the Insolvency Act.<sup>10</sup>

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<sup>8</sup> Report by Fitch Ratings *Special-Purpose Vehicles* at 6.

<sup>9</sup> See par 2.3.3 in this regard.

<sup>10</sup> 24 of 1936.

The discussion in this chapter is not intended to reflect an in-depth study of insolvency law. Rather, the general principles of the law of insolvency are stated and applied to the position during securitisation.

## 8.2 IMPEACHABLE TRANSACTIONS IN TERMS OF INSOLVENCY ACT

Section 339 of the Companies Act<sup>11</sup> provides that in the winding-up of a company unable to pay its debts, the provisions of the law relating to insolvency shall, as far as they are applicable, be applied to companies in respect of any matter not specifically provided for in the Companies Act. Section 340(1) of the Companies Act unequivocally states that the provisions of the law of insolvency relating to voidable and undue dispositions are also applicable to companies.<sup>12</sup> In the rest of this discussion I assume that the insolvent originator is a company and I refer throughout to its ‘liquidator’, even though the Insolvency Act refers to a ‘trustee’.<sup>13</sup>

The provisions of the Insolvency Act<sup>14</sup> relating to impeachable transactions may become relevant in the event of the originator’s insolvency. The liquidator of the originator could decide to set aside the sale of the assets to the SPV in order to increase the amount available to the creditors of the originator. In this paragraph I consider the chances of success of such an application.

When the court sets aside a disposition in terms of one of the sections discussed below, the trustee or liquidator is entitled to recover any property alienated in terms of the disposition. If the reversal of the transaction is no longer possible, the liquidator may claim the value of the property at the date of the disposition or at the date of the court order, whichever is highest.<sup>15</sup>

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<sup>11</sup> 61 of 1973.

<sup>12</sup> Section 340(1) reads as follows: “Every disposition by a company of its property which, if made by an individual, could, for any reason, be set aside in the event of his insolvency, may, if made by a company, be set aside in the event of the company being wound up and unable to pay all its debts, and the provisions of the law relating to insolvency shall *mutatis mutandis* be applied to any such disposition.”

<sup>13</sup> On impeachable transactions during the winding-up of companies in general, see PM Meskin, B Galgut, PAM Magid, JA Kunst, A Boraine & DA Burdette *Insolvency Law and its Operation in Winding-Up* (2007) at par 5.31.1.

<sup>14</sup> In this chapter all references to ‘the Act’ refers to the Insolvency Act.

<sup>15</sup> Section 32(3). See also Robert Sharrock, Kathleen van der Linde & Alastair Smith *Hockly’s Insolvency Law* 8 ed (2006) at 139; Bertelsmann *et al Mars* at 289–290; Meskin *et al Insolvency Law* at par 5.31.16. For a discussion of the underlying principles of impeachable transactions, see André Boraine & Ben Swart “Die Onderliggende Beginsels van die Insolvensiereg en Vernietigbare

## 8.2.1 Dispositions without value

Section 26 sets out the circumstances when a disposition without value by an insolvent debtor may be set aside by a court. Section 26(1) states that every disposition of property not made for value may be set aside by the court if such disposition left the insolvent debtor in a position where its liabilities exceeded its assets. If the disposition occurred within two years before the liquidation of the debtor,<sup>16</sup> the onus of proving the solvency of the debtor after the disposition lies with the person who received the assets.<sup>17</sup> If the disposition was made more than two years before the liquidation of the debtor, the onus lies with the liquidator to prove that the debtor was insolvent after the disposition.<sup>18</sup> For purposes of this thesis, the debtor is the insolvent originator. If at any time after the disposition the liabilities of the debtor exceeded its assets by less than the value of the property disposed of, the disposition may only be set aside to the extent of such an excess.<sup>19</sup>

### 8.2.1.1 Meaning of ‘disposition’

‘Disposition’ is defined in section 2 of the Act as

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Regshandelinge (Deel 2)” 1996 *Obiter* 213. The authors distinguish between provisions that have as a basis fraudulent conveyance and those based on preference. The former provisions are also available to creditors of the debtor while he is solvent and are aimed at dispositions made with the intention to hinder, delay or defraud the creditors of the debtor. The latter is strictly aimed at the collective procedure after the sequestration or liquidation of the debtor. Here the aim is to achieve equality between the creditors of the insolvent debtor by reversing certain transactions that fell within a specified time period before the sequestration or liquidation of the debtor. The authors’ arguments rely solely on authority from American law and they do not give any indication why they consider this legal system’s classification as relevant to a classification in the South African legal system.

<sup>16</sup> In terms of s 340(2) of the Companies Act 61 of 1973, the event that shall correspond with the sequestration order in the case of an individual shall be: “(a) in the case of a winding-up by the Court, the presentation of the application, unless that winding-up has superseded a voluntary winding-up, when it shall be the registration in terms of section 200 of the special resolution to wind up the company; (b) in the case of a voluntary winding-up, the registration in terms of section 200 of the special resolution to wind-up the company; (c) in the case of a winding-up of any company unable to pay its debts by the Court superseding a judicial management order, the presentation of the application to the Court in terms of section 433(1) or 440.” Section 433(1) and 440 relates to the cancellation of the judicial management order.

<sup>17</sup> Section 26(1)(b).

<sup>18</sup> Section 26(1)(a).

<sup>19</sup> Section 26(1). Meskin *et al Insolvency Law* at par 5.31.3 argue that it could not have been the intention of the legislature that the court should take account of any and all fluctuations in the balance sheet of the debtor in the time between the disposition and the date of winding-up. In their opinion the value of the assets must be ascertained on the date of the disposition and the difference between the assets and liabilities of the debtor must be determined on the date of the winding-up. In other words, if the property was worth R100 000 and the liabilities of the debtor exceeded its assets by only R40 000, the disposition is protected up to an amount of R60 000.

... any transfer or abandonment of rights to property and includes a sale, lease, mortgage, pledge, delivery, payment, release, compromise, donation or any contract therefore, but does not include a disposition in compliance with an order of the court ...<sup>20</sup>

The transactions listed in the definition do not form a closed list.<sup>21</sup> In essence, a disposition will include any act by which an insolvent debtor parts with an asset in his estate.<sup>22</sup> This includes a cession of claims and their accessory security rights<sup>23</sup> and the sale of claims in terms of an instalment sale transaction.<sup>24</sup> In the absence of cession, an instruction by an insolvent debtor to his debtor to pay a due amount directly to one of his creditors will constitute a disposition.<sup>25</sup> If a loan is made to the insolvent debtor, but paid into the account of a third party in settlement of a debt rather than into the account of the debtor, this will amount to a disposition.<sup>26</sup>

The meaning of ‘disposition’ is relevant also to the application of sections 29 (voidable preferences) and 30 (undue preferences) and will be referred to again when I discuss those sections. The sale of assets of the originator to the SPV in terms of a traditional securitisation scheme will constitute a disposition in terms of the definition in section 2 and the case law referred to above.

<sup>20</sup> The lumping together of so many diverging concepts in this definition was severely criticised by the Supreme Court of Appeal in *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1016F–H and 1017B. The Court described the definition as “inept in the extreme”.

<sup>21</sup> For instance, a contract of suretyship has been held to be a disposition even though it is not specifically listed. See *Langeberg Koöperasie Bpk v Inverdoorn Farming and Trading Company Ltd* 1965 (2) SA 597 (A). See Sharrock *et al Hockly’s* at 127–128 for further examples.

<sup>22</sup> *Bertelsmann et al Mars* at 250; *Meskin et al Henochsberg* at 671–672; *Meskin et al Insolvency Law* at par 5.31.2.

<sup>23</sup> *Dreyer’s Trustee v Hanekom* 1919 CPD 196 at 202. See also *Klukowski’s Trustee v Hesselman* 1923 SWA 16 at 18. Where the disposition takes the form of a cession the date of the disposition is the date of the cession and not the date when the debtor finally makes the payment due in terms of the transferred claim. See also *Sackstein NO v Van der Westhuizen* 1996 (2) SA 431 (O) at 436F.

<sup>24</sup> *Estate Sham v Young* 1936 AD 231. In this case the lessee had the right to buy the asset by paying the remainder of the purchase price. The lessee sold this right to a third party. The Court held that the trustee could only claim back compensation for the rights sold, and not the asset itself (at 240). I submit that the same reasoning will apply when a hire purchaser sells his rights in terms of a hire purchase agreement to a third party.

<sup>25</sup> *Michalow NO v Premier Milling Co Ltd* 1960 (2) SA 59 (W) (in the context of a voidable preference in terms of s 29); *Standard Finance Corporation of South Africa Ltd (In Liquidation) v Greenstein* 1964 (3) SA 573 (A) (in the context of an undue preference in terms of s 30).

<sup>26</sup> *Van Zyl NO v Turner NO* 1998 (2) SA 236 (C) (in the context of s 29).

## 8.2.1.2 Meaning of ‘value’

Contrary to the position in English law, where dispositions not for value are expressly described either as gifts or as transactions at an undervalue,<sup>27</sup> section 26 does not further describe a disposition ‘not made for value’. South African courts have held that ‘value’ does not carry any technical connotation and simply means value in the ordinary sense of the word,<sup>28</sup> meaning “a disposition for which no benefit or value is or has been received or promised as a *quid pro quo*”.<sup>29</sup> An ascertainable commercial advantage will suffice.<sup>30</sup> The benefit received by the debtor need not be a monetary or tangible consideration, but whether it represents ‘value’ must be decided by reference to all the circumstances under which the transaction was concluded.<sup>31</sup> Payment of a lawful debt is not a disposition without value, because the debtor receives a discharge of his liability in return for the payment.<sup>32</sup>

Smith<sup>33</sup> argues that the factor that distinguishes section 26 from the other provisions relating to impeachable transactions is that in this case there was no obligation on the part of the debtor to make a disposition. If she is correct, the sale of the assets to the SPV, even if at a severely discounted price, would not be avoidable under this section. The reason would be that the disposition was in terms of an agreement of sale between the originator and the SPV. However, Smith<sup>34</sup> later states that the sale of assets for entirely inadequate consideration would be a disposition not for value. This position is supported by case law. In *Terblanche NO v Baxtrans CC* the Court held that the payment of an illusory or nominal value, even in fulfilment of an obligation, would not be considered value in terms of section 26.<sup>35</sup> It therefore

<sup>27</sup> See par 3.3.3.1.

<sup>28</sup> *Estate Wege v Strauss* 1932 AD 76 at 82. The Court further held, with reference to the English Bankruptcy Act, that ‘value’ does not have the same meaning as ‘valuable consideration’ in that Act.

<sup>29</sup> *Estate Jager v Whittaker* 1944 AD 246 at 250.

<sup>30</sup> *Terblanche NO v Baxtrans CC* 1998 (3) SA 912 (C) at 915G. See further Meskin *et al Henochsberg* at 672–673; Meskin *et al Insolvency Law* at par 5.31.3.

<sup>31</sup> *Goode, Durant and Murray Ltd v Hewitt and Cornell NNO* 1961 (4) SA 286 (N) at 291F–G, followed in *Swanee’s Boerdery (Edms) Bpk (In Liquidation) v Trust Bank of Africa Ltd* 1986 (2) SA 850 (A) at 860E–F. See also Bertelsmann *et al Mars* at 254; Sharrock *et al Hockly’s* at 130.

<sup>32</sup> *Estate Jager v Whittaker* 1944 AD 246 at 250; Bertelsmann *et al Mars* at 255; Meskin *et al Insolvency Law* at par 5.31.3.

<sup>33</sup> Catherine Smith *The Law of Insolvency* 3 ed (1988) at 121.

<sup>34</sup> *Insolvency* at 123.

<sup>35</sup> *Terblanche NO v Baxtrans CC* 1998 (3) SA 912 (C) at 917C–H.

appears that the distinguishing factor is not the lack of an obligation to pay, but rather the lack of value.

One must ask whether a disposition that was not without value, but was made for a value less than adequate to compensate for the benefit received by the transferee, would fall under the provisions of section 26. The matter was left open in *Estate Jager v Whittaker*.<sup>36</sup> In *Swanee's Boerdery (Edms) Bpk (In Liq) v Trust Bank* the Appellate Division, as it then was, rejected the notion that 'value' also includes the concepts of 'adequate value' or 'just and valuable consideration'.<sup>37</sup> In its application of the law to the facts of this case the Court also did not consider the adequacy of the benefit received from the suretyships granted by the liquidated company, but only whether they resulted in any benefit or hope of a benefit taking into account all the circumstances of the case.<sup>38</sup>

In *Terblanche NO v Baxtrans CC* the Court held that inadequacy of value given in return for a disposition would rather make a transaction subject to sections 29 or 30 of the Act, because<sup>39</sup>

Inadequate value by its nature results in preferring a creditor and proof of inadequate value is evidential material to be weighed in assessing preference as also collusion and fraud and in deciding whether a disposition was in the ordinary course of business (s 29).

The Court further held that section 26 may apply where some value was given, but that value was only nominal or illusory, and the Court rejected an argument raised by the liquidator that inadequacy of value is always *prima facie* evidence of no value.<sup>40</sup>

To summarise, I submit that on the current state of authority section 26 only applies to transactions where there was no value given in return for the disposition, or where the value given is proven to be nominal or illusory. Inadequacy of value can only be a factor to consider when relying on sections 29 or 30 of the Act.<sup>41</sup> This leads to the conclusion that section 26 will not be available to a liquidator of an insolvent originator who wants to avoid the sale of the assets to the SPV. The SPV will always

<sup>36</sup> *Estate Jager v Whittaker* 1944 AD 246 at 251.

<sup>37</sup> *Swanee's Boerdery (Edms) Bpk (In Liquidation) v Trust Bank of Africa Ltd* 1986 (2) SA 850 (A) at 860E–F.

<sup>38</sup> At 860H–862E. See also *Langeberg Koöperasie Bpk v Inverdoorn Farming and Trading Company Ltd* 1965 (2) SA 597 (A) at 604H–605A; *Cronje NO v De Paiva* [1997] 2 All SA 80 (B) at 86H.

<sup>39</sup> *Terblanche NO v Baxtrans CC* 1998 (3) SA 912 (C) at 917E.

<sup>40</sup> At 917F.

<sup>41</sup> This view is supported by Meskin *et al Insolvency Law* at par 5.31.3.

pay for the transfer and there are other benefits to securitisation that will also be considered valuable by courts, such as an increase in liquidity.<sup>42</sup> The only issue that might arise is whether the consideration given in return for the disposition was adequate in terms of sections 29 or 30.

### 8.2.2 Voidable preferences

In terms of section 29(1) of the Act, every disposition made by a debtor not more than six months before the sequestration of his estate, which has the effect of preferring one of his creditors above another, may be set aside by the court, if immediately after making such a disposition the liabilities of the debtor exceeded his assets. The creditor who received the disposition can avoid the impeachment of the disposition by proving that the disposition was made in the ordinary course of business and that it was not intended thereby to prefer one creditor over another.<sup>43</sup>

The first aspect that the liquidator will have to prove is that the disposition was made less than six months before the liquidation of the originator. I submit that the insolvency of the originator should rarely occur so soon after the securitisation transaction, as the affairs of the originator come under scrutiny from rating agencies, lawyers who provide legal opinions to the rating agencies on the insolvency-remoteness of the originator and, if applicable, the securities exchange where the debt securities are to be listed. However, for the purposes of this discussion I shall explore the position should the originator be declared insolvent shortly after the securitisation transaction.

As I indicate above,<sup>44</sup> the transfer of the assets from the originator to the SPV will be a disposition in terms of the definition in the Act. The liquidator should not have difficulty in proving this requirement.

It is essential for a successful application in terms of this section that the person who directly or indirectly benefited from the disposition was an existing creditor of the insolvent debtor.<sup>45</sup> In other words, the debtor must have been under some form of

<sup>42</sup> See par 2.2 for the advantages of securitisation.

<sup>43</sup> Section 29(1). For a discussion of the section generally, see Smith *Insolvency* at 125 *et seq*; Meskin *et al Insolvency Law* at par 5.31.6.

<sup>44</sup> See par 8.2.1.1.

<sup>45</sup> *Estate Kotze v Vlok* 1923 CPD 200 at 202–203; *Caldwell's Trustee v Western Assurance Company* 1918 WLD 146 at 155; *Estate Hunt v De Villiers* 1940 CPD 79 at 90; *Coetzer v Coetzer* 1975 (3) SA 931 (E) at 934E. See also Bertelsmann *et al Mars* at 261.

duty to dispose of the property to the creditor. A donation will not be a disposition that could fall under the ambit of section 29. It is the opinion of most commentators on English law that where payment and disposition in return for the payment occur simultaneously, the transferee will not be considered a creditor in terms of section 239 of the Insolvency Act 1986,<sup>46</sup> which corresponds with section 29 of the South African Insolvency Act. I submit that there is no authority in South African law to this effect. During securitisation there will be an agreement between the originator and the SPV in terms of which the originator has a duty to dispose of the assets in favour of the SPV. The SPV will have been a creditor of the originator, even if only for a short while.

The liquidator need only prove that the disposition had the effect of preferring one creditor above the others. This is an objective test: there is no need for the liquidator to show that the debtor intended to prefer the creditor.<sup>47</sup> The court will decide whether the disposition had the effect of allowing one creditor to be paid proportionately more than the other creditors or being paid in advance of the other creditors.<sup>48</sup>

Lastly, the liquidator must prove that the liabilities of the debtor, fairly estimated, exceeded his assets fairly valued. This is also an objective test.<sup>49</sup>

#### 8.2.2.1 Defence available to person who received disposition

Once the liquidator has proved all of the above aspects, the person who received the disposition may still avoid impeachment of the transaction by proving that the disposition<sup>50</sup>

- was made in the ordinary course of business, and
- was not intended to prefer one creditor over another.

##### 8.2.2.1.1 *Ordinary course of business*

The test of whether the transaction was in the ordinary course of business is an objective one.<sup>51</sup> The court will consider, having regard to the terms of the transaction

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<sup>46</sup> See par 3.3.3.2.

<sup>47</sup> *Simon NO v Coetzee* [2007] 2 All SA 110 (T) at 114I; *Bertelsmann et al Mars* at 262; *Sharrock et al Hockly's* at 132; *Meskin et al Insolvency Law* at par 5.31.6.1.

<sup>48</sup> *Simon NO v Coetzee* [2007] 2 All SA 110 (T) at 114I. See also *Sharrock et al Hockly's* at 132.

<sup>49</sup> *Bertelsmann et al Mars* at 262; *Sharrock et al Hockly's* at 132; *Meskin et al Insolvency Law* at par 5.31.6.2.

<sup>50</sup> Section 29(1).



and the circumstances under which it was entered into, whether the transaction was one which ordinary business people would enter into in solvent circumstances.<sup>52</sup> This criterion must be satisfied without taking into account the solvency of the debtor or aspects that might show the intention to prefer.<sup>53</sup>

The court will deal with each case as it arises and according to its special circumstances.<sup>54</sup> In the case of a recognised special type of business the customs and rules of the type of business are relevant.<sup>55</sup>

I submit that it cannot be said that securitisation *per se* is a transaction that falls outside the ordinary course of business of companies. Although it has not had a long history in South Africa, it is now a well-established method of raising finance on the capital markets.

The terms and circumstances of the securitisation will have to be evaluated to determine whether they were out of the ordinary. It may be that a sale of assets to the SPV at a substantially discounted price, or where a substantial part of the payment for the transaction was deferred, may lead to a conclusion that the transaction was out of the ordinary.<sup>56</sup> However, the scheme as a whole will have to be considered in order to determine whether the discount or deferred payment could have a well-motivated ordinary business purpose.

<sup>51</sup> Bertelsmann *et al Mars* at 262; Sharrock *et al Hockly's* at 132; Meskin *et al Insolvency Law* at par 5.31.6.3.

<sup>52</sup> *Estate Van Schalkwyk v Hayman & Lessem* 1947 (2) SA 1035 (C) at 1044; *Hendriks NO v Swanepoel* 1962 (4) SA 338 (A) at 342F and 345A; *Joosab v Ensor NO* 1966 (1) SA 319 (AD) at 326E; *S v Schwartz* 1972 (2) SA 295 (C) at 304C; *Paterson NO v Trust Bank of Africa Ltd* 1979 (4) SA 992 (A) at 997A–D; *Amalgamated Banks of South Africa Bpk v De Goede* 1997 (4) SA 66 (SCA) at 77I–J; *Van Zyl NO v Turner NO* 1998 (2) SA 236 (C) at 245E. See also *Smith Insolvency* at 128; *Bertelsmann et al Mars* at 262; *Sharrock et al Hockly's* at 132.

<sup>53</sup> *Pretorius' Trustee v Van Blommenstein* 1949 (1) SA 267 (O) at 273–274; *Hendriks NO v Swanepoel* 1962 (4) SA 338 (A) at 342G.

<sup>54</sup> *Van Zyl NO v Turner NO* 1998 (2) SA 236 (C) at 245C–D. In *Estate Van Schalkwyk v Hayman & Lessem* 1947 (2) SA 1035 (C) the insolvent obtained permission from his bondholders to sell certain mineral rights on condition that money received from that transaction would be paid to them. He did not pay them the money after receiving it, but paid other creditors. The Court considered this to be beyond the ordinary course of business (at 1048). See also *Bertelsmann et al Mars* at 263.

<sup>55</sup> In *Hendriks NO v Swanepoel* 1962 (4) SA 338 (A) at 343G–344D the Court considered the usual practices applied by sheep farmers as a 'special kind of business'. The majority decision, however, held that sheep farming is not a special kind of business and that the actions of the parties had to be considered with reference to the practices of normal solvent business persons (at 345H–346A). See further *Bertelsmann et al Mars* at 263; *Smith Insolvency* at 129; *Sharrock et al Hockly's* at 133; *Meskin et al Insolvency Law* at par 5.31.6.3.

<sup>56</sup> In *Terblanche NO v Baxtrans CC* 1998 (3) SA 912 (C) at 917E the Court held that a disposition at an undervalue has evidentiary value in determining whether a transaction was in the ordinary course of business.

It should also be remembered that securitisation is still developing, with a lot of innovation in the types of assets securitised and in the structure of the schemes. Just because a particular securitisation transaction was not structured exactly like any other transaction before it, does not mean that it was not concluded in the ordinary course of business.

#### 8.2.2.1.2 *Intention to prefer*

The person to whom a disposition was made can avoid impeachment of the transaction by proving that the disposition was not made with the intention to prefer. In order to establish an intention to prefer, there must have been an intention on the debtor's part to disturb what would be the proper distribution of his assets in insolvency.<sup>57</sup>

The Act does not require that the debtor must have contemplated his liquidation at the time of the disposition, but it cannot be contended that the debtor intended to prefer one creditor over the others without proof that he foresaw his liquidation.<sup>58</sup> What must be proved is that the debtor knew that his liquidation is “substantially inevitable”.<sup>59</sup> However, even if he did foresee the possibility of his liquidation that does not necessarily mean that he had the intention to prefer the creditor in making the disposition. Other factors may show that this was not the overriding intention.<sup>60</sup>

In the context of section 29(1) ‘intention to prefer’ means the dominant motive or primary object to prefer.<sup>61</sup> It implies that the debtor must have acted out of his free

<sup>57</sup> *Smith v Carpenter* 1869 Buch 206 at 215; *Slater's Trustee v Smith* 5 (1885) EDC 9 at 16–17; *Bertelsmann et al Mars* at 266; *Sharrock et al Hockly's* at 134.

<sup>58</sup> *Fearnley's Trustee v Netherlands Bank* 1904 TS 424 at 429–430: “But in order to prove an intention to prefer, it appears to me that it is necessary to prove that there was contemplation of insolvency, for I do not see how a man can be held to have intended to prefer one creditor before his other creditors unless he had insolvency in contemplation at the time, since no question of preference can arise until he contemplates insolvency.” See also *Malherbe's Trustee v Dinner* 1922 OPD 18 at 24–25; *Van Eeden's Trustee v Pelunski & Mervis* 1922 OPD 144 at 148; *Featherstone's Estate v Elliot Bros* 1922 EDL 233 at 241–242; *Myburgh, Krone & Co Ltd v Standard Bank of SA Ltd* 1924 CPD 122 at 141; *Pretorius NO v Stock Owners' Co-operative Co Ltd* 1959 (4) SA 462 (A) at 472E–F; *Venter v Volkskas Ltd* 1973 (3) SA 175 (T) at 179E; *S v Ostilly* 1977 (4) SA 699 (D) at 731G–H; *Du Plessis NO v Oosthuizen* 1999 (2) SA 191 (O) at 212G; *Fourie NO v Edeling NO* [2005] 4 All SA 393 (SCA) at 399I–400B; *Bertelsmann et al Mars* at 267; *Smith Insolvency* at 133; *Sharrock et al Hockly's* at 134; *Meskin et al Insolvency Law* at par 5.31.6.4.

<sup>59</sup> *Pretorius NO v Stock Owners' Co-operative Co Ltd* 1959 (4) SA 462 (A) at 472H–473A.

<sup>60</sup> *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1029H–1030B.

<sup>61</sup> *S v Ostilly* 1977 (4) SA 699 (D) at 731B; *Van Zyl NO v Turner NO* 1998 (2) SA 236 (C) at 244G; *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1026G; *Smith Insolvency* at 134.

will. If the disposition was primarily intended to stave off criminal prosecution, the Court has held that there was no intention to prefer.<sup>62</sup>

Another important consideration will be whether the creditor's claim existed before the disposition. The object of a voidable preference is not to obtain credit or raise money from an outside source, but to provide an existing creditor with an advantage in respect of an existing debt.<sup>63</sup>

The test to determine whether the debtor had the requisite intention is subjective.<sup>64</sup> The court will take into account all possible reasons for the disposition and will then come to a conclusion on the intention of the debtor on a preponderance of probability.<sup>65</sup> There must have been a real intention to prefer one creditor. It is not enough to show that the debtor did not consider the fact that the disposition will prefer one creditor above the others.<sup>66</sup> It is also insufficient to show that the debtor should have known that the effect of the disposition would be to prefer a specific creditor.<sup>67</sup> There must have been an actual intention to prefer.

I submit that the primary objective with securitisation will seldom be to prefer one creditor over the others in the event of the originator's insolvency. The usual objective when an originator enters into such a scheme is to obtain financing. Consequently, it is my opinion that an attempt by a liquidator to rely on section 29 to impeach the sale of assets by an originator to an SPV will fail, except under the most extraordinary circumstances.

<sup>62</sup> *Van Zyl NO v Turner NO* 1998 (2) SA 236 (C) at 244H–245A; *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1030H; *Smith Insolvency* at 135.

<sup>63</sup> *Malherbe's Trustee v Dinner* 1922 OPD 18 at 25; *Van Eeden's Trustee v Pelunski & Mervis* 1922 OPD 144 at 148; *Bertelsmann et al Mars* at 272.

<sup>64</sup> *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1026H–1027A; *Bertelsmann et al Mars* at 267; *Smith Insolvency* at 132. In their discussion of the *Cooper* decision, *Burdette & Boraine 2000 Obiter* at 488–489 advocate an amendment of s 29 to do away with the subjective element. This is the approach in American law, where preference law is based on an objective determination of the financial position of the debtor and the effect of the preference on the other creditors. See par 4.3.2.3.2.

<sup>65</sup> *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1027F; *Bertelsmann et al Mars* at 270; *Smith Insolvency* at 134; *Sharrock et al Hockly's* at 135.

<sup>66</sup> *Cooper NNO v Merchant Trade Finance Ltd* 2000 (3) SA 1009 (SCA) at 1029C–D.

<sup>67</sup> *Pretorius' Trustee v Van Blommenstein* 1949 (1) SA 267 (O) at 270; *Du Plessis NO v Oosthuizen* 1999 (2) SA 191 (O) at 212I; *Bertelsmann et al Mars* at 269; *Meskin et al Insolvency Law* at par 5.31.6.4.

### 8.2.3 Undue preferences

In terms of section 30(1), a court may set aside a disposition of the debtor's property, when it was made at a time when the debtor's liabilities exceeded his assets and if the disposition was made with the intention to prefer one of his creditors above the others.

One difference between this section and section 29 is that the onus of proving that the disposition was made with the intent to prefer lies with the liquidator.<sup>68</sup> It is not sufficient to show that the disposition had the effect of preferring a specific creditor, as is required in terms of section 29.<sup>69</sup> The substantive requirements of proving such intent are the same as those discussed above regarding section 29.<sup>70</sup> Any disposition may be set aside, regardless of the time that lapsed between the disposition and the order for liquidation.<sup>71</sup> Furthermore, if the liquidator can prove the requirements of the section, the court must set aside the disposition. There are no defences available to the person who benefited from the disposition.<sup>72</sup>

I already mentioned in my discussion of section 29 that it is most unlikely that the originator will be insolvent after the transfer of the assets to the SPV.<sup>73</sup> However, even if the liquidator could prove that the originator was insolvent at the time of the sale of the assets to the SPV, I submit that it would be difficult to prove that the disposition was made with the "dominant motive or primary object"<sup>74</sup> of preferring the SPV to the other creditors of the originator. Securitisation is primarily a method of financing. It requires extensive planning and the involvement of several outside parties. Some of these parties, such as rating agencies or proposed trustees for debenture-holders, will object if they suspect that the originator's intention with the transaction is not financing. I therefore do not see that an application in terms of section 30 will be a viable option to impeach the sale of the assets to the SPV.

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<sup>68</sup> Bertelsmann *et al Mars* at 273; Sharrock *et al Hockly's* at 135; Meskin *et al Insolvency Law* at par 5.31.9.

<sup>69</sup> Smith *Insolvency* at 136.

<sup>70</sup> See par 8.2.2.1.2.

<sup>71</sup> Sharrock *et al Hockly's* at 135; Smith *Insolvency* at 136.

<sup>72</sup> Bertelsmann *et al Mars* at 273; Smith *Insolvency* at 137.

<sup>73</sup> See par 8.2.2.

<sup>74</sup> See n 61 above.

### 8.2.4 Collusive dispositions

Where a debtor before being liquidated has disposed of some of its property in collusion with another person, which had the effect of prejudicing its creditors or preferring one creditor over others, the court may set aside the disposition after liquidation.<sup>75</sup> Any person who was a party to such collusive dealings is liable to the insolvent estate for any loss caused to the estate and for any penalty fee ordered by the court, which amount may not exceed the amount by which he benefited from the transaction.<sup>76</sup> If such a person is also a creditor of the estate he shall forfeit his claim against the estate.<sup>77</sup> The onus of proving that these requirements are met lies with the liquidator.<sup>78</sup> The onus is discharged on a preponderance of probability.

‘Collusion’ in the context of section 31 means an agreement which has a fraudulent purpose and not merely an agreement which has the effect of preferring one creditor above the others.<sup>79</sup> The party with whom the debtor colluded need not be a creditor of the debtor, but can be any person. However, there must be proof that two minds were concurring to defraud the estate,<sup>80</sup> or that the debtor was conniving with another person to do some act knowing that it was unlawful or dishonest and with the object of fraud or deceit.<sup>81</sup> The liquidator must prove that at the time of the disposition the defendant was aware that the disposition would have the effect of prejudicing the creditors of the debtor or preferring one creditor over the others. There is a presumption that the defendant was aware of such harm if he knew at the time of the disposition that the financial position of the debtor was “hopeless”.<sup>82</sup> Disguising the

<sup>75</sup> Section 31(1). See also Sharrock *et al Hockly's* at 135–136; Smith *Insolvency* at 138; Meskin *et al Insolvency Law* at par 5.31.12.

<sup>76</sup> The person need not have been a creditor of the debtor at any material time. See *Morris NO v Airomatic (Pty) Ltd t/a Barlows Airconditioning Co* 1990 (4) SA 376 (A) at 395D.

<sup>77</sup> Section 31(2); Bertelsmann *et al Mars* at 273–274.

<sup>78</sup> Bertelsmann *et al Mars* at 273 and 275; Smith *Insolvency* at 139.

<sup>79</sup> *Meyer NO v Transvaalse Lewendehawe Koöperasie Bpk* 1982 (4) SA 746 (A) at 771C–D. Bertelsmann *et al Mars* at 274.

<sup>80</sup> *Gert de Jager Bpk v Jones NO* 1964 (3) SA 325 (A) at 331A; *Coetzer v Coetzer* 1975 (3) SA 931 (E) at 936C–D; *Meyer NO v Transvaalse Lewendehawe Koöperasie Bpk* 1982 (4) SA 746 (A) at 771C–E.

<sup>81</sup> *Van der Westhuizen's Trustee v Van der Westhuizen* 1923 CPD 70 at 76; *McLean v McLean's Trustee* 1923 AD 140; *Baldachin's Trustees v Sloman & Sloman* 1944 SR 55 at 60.

<sup>82</sup> *Estate Lala v Mahomed* 1944 AD 324 at 332; *Foot NO v Vorster* 1983 (3) SA 179 (O) at 187H; Bertelsmann *et al Mars* at 275.

true nature of a transaction so that creditors will be prejudiced in the event of the debtor's insolvency has been held to be a collusive dealing.<sup>83</sup>

In my analysis of American law I set out the arguments of various authors for and against the proposition that securitisation is to the detriment of the unsecured creditors of the originator.<sup>84</sup> From this analysis it emerged that there will only truly be an answer to this proposition when empirical research is undertaken on the effect of the securitisation on the unsecured creditors of the originator in the event of his subsequent insolvency.

However, I submit that even if it is proved that securitisation is harmful to the unsecured creditors of the originator, most securitisation transactions are not undertaken with the fraudulent intent required for an impeachment in terms of section 31. Most securitisation transactions aim to benefit the estate of the originator by providing it with liquidity.<sup>85</sup> Even if the managers of the originators then utilise the funds obtained from the securitisation transaction for illegal or wasteful purposes it does not necessarily show that the various parties involved in the securitisation scheme shared their fraudulent motives.

It is conceivable that a securitisation transaction could be set up in order to prejudice the creditors of the originator, especially if the managers or owners want to squander the cash injection. It is also possible that reputable institutions may be willing to assist in the structuring of the scheme. Involvement in the structuring of securitisation schemes is lucrative. This includes rating agencies, who base their opinions on the quality of the transferred assets and on the structure of the scheme.<sup>86</sup> They have no interest in the motives behind the transaction.

I submit that if a liquidator can prove that one or more of the parties involved in the securitisation scheme were part of any collusion to prejudice the creditors of the originator, this section is the most appropriate under which to proceed to set aside the transfer of the assets to the SPV, as well as to penalise those who benefited from the transaction. It is unnecessary under this section to show that the person involved in

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<sup>83</sup> *Baldachin's Trustees v Sloman & Sloman* 1944 SR 55 at 60. In this case the defendants drew up a false document to create the impression that they were the owners of certain equipment and that the debtor was only in possession of the equipment in terms of a hire-purchase agreement, so that the equipment would fall outside the estate of the debtor on his insolvency.

<sup>84</sup> See par 4.3.2.1.2.

<sup>85</sup> See par 2.2.1.

<sup>86</sup> See par 2.6 *et seq.*

the collusion was a creditor of the debtor. Many of the parties involved in a securitisation scheme, such as the credit enhancers and rating agencies, will be creditors of the SPV rather than of the originator, and will therefore be immune from action in terms of the other sections of the Act. The court may further order penalty sums against those involved in the collusive dealings.

If fraud was the main motive behind the securitisation scheme, the party most likely to be a defendant in the proceedings will be the SPV. Under such circumstances the directors of the SPV will probably have colluded with the originator. The transfer of the assets to the SPV will be set aside and the SPV will lose all claims against the insolvent estate of the originator.

The investors in the SPV will have to rely on section 33(2) of the Act to protect their interests.<sup>87</sup> How a court will manage not to affect the interests of the investors despite setting aside the disposition is open to speculation as there is no precedent to give us guidance in this regard. It is clear that the SPV will be insolvent after the setting aside of the disposition. In my opinion, there are two options to protect the interests of the investors of the SPV. First, the court can refuse to set aside the disposition, because it will inevitably lead to the prejudice of the rights of the investors. Second, the court could order that the SPV be liquidated first. However, the latter option will to my mind still affect the rights of the investors, who depended on the insolvency-remoteness of the SPV from the originator and might not receive the full amount due to them.

No section of the business community is completely safe from the effects of fraud. Securitisation is no exception, but I submit that the involvement of so many parties in a conventional securitisation scheme leads to self-regulation and that makes the use of this form of financing an unlikely vehicle to commit fraud.

### **8.2.5 Indemnity to creditors and rights of third parties**

A person who, on receipt of the impeachable disposition in terms of section 26, 29, 30 or 31 parted with property or security, or lost any right he held against another person, while acting in good faith, is not obliged to return the property to the liquidator before the latter has indemnified him for parting with such property or security, or the loss of

<sup>87</sup> See par 8.2.5 below.

such a right.<sup>88</sup> The onus of pleading and proving the requirements of this section lies with the creditor. The purpose of this provision is that when a disposition is set aside, both the parties must be restored to the position before the disposition.<sup>89</sup> The property or security parted with, or the right lost, must have been in exchange for the impeached disposition.

The good faith required in terms of the subsection will be determined by looking at the whole of the operation or transaction that gave rise to the disposition and not only with reference to the recipient's conduct when he parted with the property, security or right.<sup>90</sup> The recipient will have to show that he did not mean to prejudice the other creditors of the debtor or to be preferred above them when he entered into the transaction. The recipient of a disposition set aside due to collusive dealings will therefore not be able to rely on this provision.<sup>91</sup>

In the event of a successful application by the liquidator of an originator to set aside the sale of the assets to the SPV, the SPV will be able to rely on this indemnity. The transaction may still be set aside, but the liquidator will not be able to insist on compliance with the court's order for impeachment before he has delivered the indemnity to the creditor. The indemnity will be for the amount paid by the SPV as purchase price for the transferred assets. Indemnity can be avoided if there are reasons to believe that the SPV was aware of the originator's insolvency at the time of the disposition and therefore did not act in good faith. The onus of proving that it acted in good faith lies with the SPV. I therefore recommend that the SPV should obtain a statement by the auditors of the originator or at least by the originator itself, to the effect that the originator is solvent at the time of the securitisation transaction and that the transaction will further not leave the originator insolvent.

An impeachment of a transaction as described in the previous paragraphs may not affect the rights of third persons, such as the investors in the securitisation scheme, who received property from a person other than the insolvent person, and who acted

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<sup>88</sup> Section 33(1); *Bertelsmann et al Mars* at 290–291; *Sharrock et al Hockly's* at 139; *Meskin et al Insolvency Law* at par 5.31.19.1.

<sup>89</sup> *Barclays National Bank Ltd v Umbogintwini Land and Investment Co (Pty) Ltd (In Liquidation)* 1985 (4) SA 407 (D) at 411B–C; *Geyser NO v Telkom SA Ltd* 2004 (3) SA 535 (T) at 546C–D.

<sup>90</sup> *Ruskin NO v Barclays Bank DCO* 1959 (1) SA 577 (W) 584H–585A; *Geyser NO v Telkom SA Ltd* 2004 (3) SA 535 (T) at 549F; *Bertelsmann et al Mars* at 291; *Sharrock et al Hockly's* at 139.

<sup>91</sup> *Meskin et al Insolvency Law* at par 5.31.19.1.



in good faith and for value.<sup>92</sup> ‘Good faith’ refers to the absence of an intention to prejudice creditors or to be preferred above the other creditors of the debtor. There is some authority for the view that this provision does not only protect persons who became the owners of the disposed property, but also persons who acquired real rights over such property, such as security rights.<sup>93</sup>

The SPV will not be able to benefit from this provision, because it acquired the property from the insolvent person’s estate. However, the investors in the SPV will have acquired security rights over the assets transferred to the SPV. In my view, regardless of the form of security chosen to protect the rights of the investors, this section can be used to avoid the impeachment of the disposition. The investors in the SPV would have parted with their money to purchase securities issued by it. In return they would have received securities, which are secured by the assets transferred to the SPV by the originator. Under normal circumstances these investors would have acted in good faith.

I therefore submit that even if the liquidator impeaches the disposition of the transferred assets to the SPV, the court can be asked not to impeach the transaction because it would prejudice the rights of these third parties.

### 8.3 TRANSFER OF BUSINESS BY TRADER

Section 34 provides that a trader who in terms of a contract transfers any business belonging to him, or the goodwill of such a business, or any goods or property forming part thereof, must publish a notice of the intended transfer in the *Government Gazette* and in two issues of an English and two issues of an Afrikaans newspaper circulating in the district where the business is carried on, within not less than 30 days and not more than 60 days before the date of the transfer. If this notice is not given in the prescribed manner the transfer is void against the creditors of the trader for a period of six months after the transfer, as well as against the trustee or liquidator of the trader’s estate if the estate is sequestrated or liquidated within the six month period. The trader will only be exempt from this requirement if such transfers are in the ordinary course of that business or if the transfer was carried out for securing the

<sup>92</sup> Section 33(2); Bertelsmann *et al Mars* at 290; Meskin *et al Insolvency Law* at par 5.31.20.

<sup>93</sup> *Siebert’s Trustee v Siebert* 6 EDC 218.

payment of a debt.<sup>94</sup> The provisions of section 34 are applicable to the transfer of its business by a company.<sup>95</sup>

After such a notice has been given, every liquidated liability of the trader in connection with the business, which would become due at some future date, will fall due immediately if the creditor demands payment of the debt. The trader would then have to pay such a creditor, provided that the amount of his liability must be reduced at a rate of eight per cent per annum over the period between the date when the payment is made and the future date on which it should have become payable.<sup>96</sup>

The section therefore not only provides for the publication of the transfer, but also provides an opportunity for a creditor of the trader to opt out of his relationship with the trader. The creditors of the trader are granted this opportunity regardless of the reason for the transfer. Even if the transfer has a legitimate business purpose and the trader is not experiencing any financial difficulties, it may seem to third parties that the trader is in financial difficulty when creditors start to demand payment.

Such suspicions are supported by the purpose behind this section, namely to prevent traders in financial difficulties from disposing of their businesses to third parties who are not liable for the business debts, without due advertisement to all creditors of the business.<sup>97</sup> However, financial difficulty is not a prerequisite for the applicability of the section. It applies to all traders who are about to sell a part of their businesses.

Owing to the possible negative signalling that publication of the notice gives to third parties, most businesses prefer not to publish the required notice. Originators during securitisation transactions would likewise prefer not to publish the transfer of assets to the SPV in the manner prescribed in section 34.

<sup>94</sup> Section 34(1) of the Insolvency Act 24 of 1936. See also Bertelsmann *et al Mars* at 276; Sharrock *et al Hockly's* at 141–144.

<sup>95</sup> Section 340(1) of the Companies Act 61 of 1973; *Galaxie Melodies (Pty) Ltd v Dally NO* 1975 (4) SA 736 (A) at 745A; *Ensor NO v Rensco Motors (Pty) Ltd* 1981 (1) SA 815 (A) at 821B–D. See also Meskin *et al Henochsberg* at 674.

<sup>96</sup> Section 34(2). See also Bertelsmann *et al Mars* at 279–280.

<sup>97</sup> *Harrismith Board of Executors v Odendaal* 1923 AD 530 at 538; *Cronje NO v Paul Els Investments (Pty) Ltd* 1982 (2) SA 179 (T) at 193B–D; *Galaxie Melodies (Pty) Ltd v Dally NO* 1975 (4) SA 736 (A) at 744A; *Gore NNO v Saficon Industrial (Pty) Ltd* 1994 (4) SA 536 (W) at 545G; *McCarthy Ltd v Gore NO* [2007] SCA 32 RSA (unreported, case nr 163/06, 28 March 2007) at [8]; Bertelsmann *et al Mars* at 276.

I submit that it will be possible for most originators to avoid publication of a notice in terms of section 34, because most originators do not fall under the definition of ‘trader’ in terms of the Act. In terms of section 2 of the Act ‘trader’ is defined as

any person who carries on any trade, business, industry or undertaking in which property is sold, or is bought, exchanged or manufactured for purpose of sale or exchange, or in which building operations of whatever nature are performed, or an object whereof is public entertainment, or who carries on the business of an hotel keeper or boarding-house keeper, or who acts as a broker or agent of any person in the sale or purchaser of any property or in the letting or hiring of immovable property; and any person shall be deemed to be a trader for the purpose of this Act ... unless it is proved that he is not a trader as hereinbefore defined.

In *McCarthy Ltd v Gore NO* the Supreme Court of Appeal held that this definition is meant to create a closed list of categories under which a business must fall before it will be required to publish the notice in terms of section 34.<sup>98</sup> It is therefore not any trade, business, industry or undertaking that falls under the definition, but only those engaged in the categories of operations listed in the definition.

The definition is further limited by looking at the nature of the undertaking that will lead to the transfer and determining whether such an undertaking is part of the core business of the company or incidental thereto. If the undertaking is not part of its core activities the business will not be a trader for the purposes of section 34. For instance, in the *McCarthy Ltd* decision the core business of the transferor was that of a transport haulier conveying goods on a long-haul basis. The Court held that the occasional factoring of book debts and selling of part of its fleet was incidental to its core business and did not qualify the business as a trader in terms of section 34.<sup>99</sup>

I submit that based on the definition of ‘trader’, read with the restrictive interpretation by the Supreme Court of Appeal of that definition, most financial institutions that engage in securitisation in South Africa will not fall under the definition. Commercial banks and asset-financing institutions are not in the business of buying and selling property, nor do their businesses fall under one of the other categories set out in the definition.

<sup>98</sup> [2007] SCA 32 RSA (unreported, case nr 163/06, 28 March 2007) at [10], approving *Kevin and Lasia Property Investment CC v Roos NO* 2004 (4) SA 103 (SCA) at 108G–I. For a discussion of this case, see Alastair Smith “A Trader’s Primary Business Activities and Incidental Activities under Sections 2 and 34(1) of the Insolvency Act 24 of 1936” (2007) 19 *SA Merc LJ* 407. See further Meskin *et al Insolvency Law* at par 5.31.18.1.

<sup>99</sup> See also *Roos NO v Kevin and Lasia Property Investment BK* [2005] JOL 15748 (T) at [20] and [21]. Here the Court held that the business of the company was that of a property investment company. The one-off selling of some of its immovable property did not change it into a trader for purposes of s 34. See also Bertelsmann *et al Mars* at 277.

The issue becomes more problematic when the originator would usually resort under the definition of ‘trader’ and now wants to engage in a securitisation transaction. For instance, the originator is a furniture retailer who extends credit as a normal part of its business. It now wants to securitise a portion of its claims. One needs to determine whether the claims will be “property forming part of the trader’s business” for purposes of section 34.

The definition of ‘property’ in section 2 of the Act does not shed much light on this question. It defines ‘property’ as “movable or immovable property wherever situate within the Republic and includes contingent interests in property”. ‘Movable property’ is further defined as “every kind of property and every right or interest which is not immovable property.” In terms of these definitions a claim will be property for purposes of the Act.

However, section 34 also requires such property to form part of the trader’s business before its transfer will be subject to the notice requirements of the section. The interpretation of ‘forming part of’ was considered by the Supreme Court of Appeal in *Kelvin Park Properties CC v Paterson NO*.<sup>100</sup> The Court warned against formulating a test for the interpretation of this phrase too broadly and indicated that each matter had to be considered according to the facts of the particular case.<sup>101</sup>

There is no guidance from case law on whether the securitisation of claims resulting from the business of a retailer will form part of the business of the retailer. I am of the opinion that the courts will probably consider the claims as forming part of the retailer’s business. The transfer of the claims from the originator to the SPV will therefore *prima facie* have to comply with the notice requirements of section 34. The only possible way in which to avoid the giving of such notice will be to convince the court that securitisation is part of the ordinary course of business of that retailer.

Whether a transaction was in the ordinary course of business is an objective test, in other words, whether it is a transaction in which solvent businessmen would ordinarily engage.<sup>102</sup> The court will further consider the normal business practices of

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<sup>100</sup> 2001 (3) SA 31 (SCA).

<sup>101</sup> At 36D–E. In this particular case the asset, the premises from which the business was run, was held to have been part of the business. Among other aspects that the Court considered in reaching this conclusion, was the fact that the premises had been adapted for the purposes of accommodating a butchery and that an employee of the business made use of the living space above the butchery as part of his employee benefits (at 36H–37D). See also Bertelsmann *et al Mars* at 277.

<sup>102</sup> *Joosab v Ensor NO* 1966 (1) SA 319 (A) at 326 D–E. See par 8.2.2.1.1 above.

the particular business of the trader in question to decide whether the transaction falls within the exception.<sup>103</sup> The fact that the disposition of the property was advantageous to the business, or even that a price was paid for the items in excess of their market value, will not lead to a conclusion that the transaction was in the ordinary course of that business.<sup>104</sup> In other words, proof that a securitisation transaction was advantageous to the business of the trader will not lead to the conclusion that the transaction was in the ordinary course of the business of that trader. It has also been held that the fact that the transaction was undertaken openly and honestly does not necessarily support a finding that it was in the ordinary course of the business of the trader.<sup>105</sup>

I do not believe that securitisation as a means of financing by the retail industry has yet reached the level of acceptance in South Africa necessary to be able to use this exception to section 34. A court might find that securitisation falls in the ordinary course of a retailer's business after it has successfully organised one or more past securitisations. However, for a first-time securitisation I believe that the originator, if it falls within the definition of trader generally, will have to comply with the notice requirements of section 34.

#### **8.4 DISPOSITIONS VOIDABLE AT COMMON LAW: *ACTIO PAULIANA***

The discussion in the previous paragraph sets out the provisions in terms of the Insolvency Act by which the disposition of assets by an originator to an SPV in terms of a securitisation transaction may possibly be set aside. There is a further possible action in terms of the common law by which the liquidator of the originator may attempt avoidance of the disposition of the assets to the SPV, namely the *actio Pauliana*.<sup>106</sup>

<sup>103</sup> In *Ensor NO v Rensco Motors (Pty) Ltd* 1981 (1) SA 815 (A) the Court held that a disposition of assets back to a franchisor in terms of a franchise agreement was in the ordinary course of the franchisee's business and did not resort under section 34. In *Gore NNO v Saficon Industrial (Pty) Ltd* 1994 (4) SA 536 (W) it was held that regard must be had to the ordinary business practices of the business that made the disposition and not to the normal practices of the companies of the group. See also Bertelsmann *et al Mars* at 279.

<sup>104</sup> *Joosab v Ensor NO* 1966 (1) SA 319 (A) at 326H–327A; *Gore NNO v Saficon Industrial (Pty) Ltd* 1994 (4) SA 536 (W) at 545G.

<sup>105</sup> *Gore NNO v Saficon Industrial (Pty) Ltd* 1994 (4) SA 536 (W) at 547D.

<sup>106</sup> On the *actio Pauliana* in general, see Bertelsmann *et al Mars* at 280–283; Sharrock *et al Hockly's* at 136–137; André Boraine “Towards Codifying the *actio Pauliana*” (1996) 8 *SA Merc LJ* 213.

The *actio Pauliana* is available when a debtor has entered into a transaction in fraud of and to the actual detriment of his creditors. The transaction can then be set aside by the court and the property disposed of can be recovered.<sup>107</sup> It is not essential that the estate of the debtor must be under liquidation.<sup>108</sup>

‘Fraud’ when used in connection with the *actio Pauliana* does not necessarily refer to fraud in the criminal sense of the word, but means that the object of the transaction was to provide a specific creditor with an unfair advantage, which constitutes a fraud upon other creditors.<sup>109</sup> The intention to defraud its creditors could be only that of the debtor, or the intention may be shared by the recipient of the disposition.<sup>110</sup> In the former case the disposition can only be set aside with the *actio Pauliana* if the recipient received the disposition gratuitously and even then only to the extent that he was enriched by the acquisition.<sup>111</sup>

Since the transfer of the assets from the originator to the SPV will always be for value, the *actio Pauliana* will only be available if it can be proved that the SPV acted in collusion with the originator in the transfer of the assets. It may also be pleaded as an alternative to section 31 of the Insolvency Act.<sup>112</sup> Since section 31 offers the additional remedy of a penalty fee,<sup>113</sup> the liquidator will usually proceed on the basis of that section before resorting to the *actio Pauliana*, which only provides for the restitution of the alienated property.<sup>114</sup>

If the action is successful and the property must be restored to the insolvent estate, the purchaser, if party to the fraud, is not entitled to restitution of the purchase price paid by him if the money is no longer in the estate of the debtor.<sup>115</sup>

<sup>107</sup> On the history of the *actio Pauliana* generally, see Johan Albert Ankum *De Geschiedenis der ‘Actio Pauliana’* (1962), especially at 99 *et seq.*

<sup>108</sup> *Fenhalls v Ebrahim* 1956 (4) SA 723 (N) at 728H.

<sup>109</sup> *Chin’s Trustee v National Bank* 1915 AD 353 at 363; *Beddy NO v Van der Westhuizen* 1999 (3) SA 913 (SCA) at 916H–I; See also Bertelsmann *et al Mars* at 281.

<sup>110</sup> *Chin’s Trustee v National Bank* 1915 AD 353 at 363.

<sup>111</sup> *Scharff’s Trustee v Scharff* 1915 TPD 463 at 476; *Kommissaris van Binnelandse Inkomste v Willers* 1999 (3) SA 19 (SCA) at 28H–29A; Meskin *et al Insolvency Law* at par 5.31.17; Boraïne 1996 SA *Merc LJ* at 219.

<sup>112</sup> 24 of 1936. See Meskin *et al Insolvency Law* at pars 5.31.12 and 5.31.17.

<sup>113</sup> See par 8.2.4 above.

<sup>114</sup> Meskin *et al Insolvency Law* at par 5.31.17.

<sup>115</sup> Voet *Commentarius* 42.8.19.

## 8.5 CONCLUSION

In the absence of fraud, there is virtually no risk that the liquidator of an insolvent originator will be able to impeach the transfer of the assets from the originator to the SPV successfully. This is the position notwithstanding the fact that the transfer itself will be a ‘disposition’ in terms of section 2 of the Insolvency Act 24 of 1936.

If the transfer of the assets to the SPV is impeached by any of the methods discussed in this chapter, the provisions of Chapter VIII of the Banks Act 94 of 1991 become applicable. This conclusion is based on the requirement of Securitisation Notice, 2008 that the sale of the assets from the originator to the SPV must withstand legal scrutiny, also in the case of the originator’s subsequent insolvency.

Section 26 of the Insolvency Act is only available if no value was received for the disposition.<sup>116</sup> During a securitisation transaction the transfer of the assets will always be accompanied by payment by the SPV. Furthermore, financing by means of securitisation provides certain benefits that can also be regarded as value for purposes of this section.<sup>117</sup> Arguments that the payment or other benefits received in return for the transfer of the assets to the SPV are inadequate, do not properly resort under section 26, but must be raised in connection with a voidable preference in terms of section 29 or an undue preference in terms of section 30.

It is a requirement of section 29 that the debtor must have been insolvent immediately after the disposition and of section 30 that the debtor was insolvent at the time of the disposition. I indicated that it is most unlikely that an insolvent originator will be able to enter into a securitisation transaction. The affairs of the originator are scrutinised by rating agencies, lawyers who provide legal opinions to the rating agencies on the insolvency-remoteness of the originator and, if applicable, the securities exchange where the debt securities are to be listed.

However, even in the unlikely event that the originator is found to have been insolvent at the time of the transfer of the assets to the SPV, I argued that the chances for success under section 29 and 30 are limited. The SPV will be a creditor of the originator for purposes of section 29 and the transfer will have the effect of preferring the SPV to other creditors, which means that the liquidator will have satisfied the

<sup>116</sup> Paragraph 8.2.1.

<sup>117</sup> See par 2.2.

*prima facie* onus of proof required by the section.<sup>118</sup> However, section 29 provides a defence to the creditor, namely that the transaction was in the ordinary course of the business of the debtor and that there was no intention to prefer. I pointed out that this defence will be available to the SPV in most cases.

Although only in use for 20 years, securitisation is now an established form of financing.<sup>119</sup> It cannot be contended that securitisation *per se* is extraordinary, although the terms of each transaction will have to be evaluated to determine whether a particular transaction fell outside the parameters of the ordinary course of business of the debtor. It must further be remembered that one securitisation scheme will often not be identical in its structure to others.

The evaluation of the requirements of the “intention to prefer” in terms of section 29 showed that the motivation of an originator to enter into a securitisation scheme will seldom amount to a primary or dominant intention to prefer the SPV to its other creditors.<sup>120</sup> The primary intention behind most securitisation schemes, which are scrutinised by various role-players other than the originator, is financing and the benefits that arise from this particular method of financing.

For the same reason, I do not envisage that a liquidator will be able to rely successfully on the provisions of section 30. This section does not carry the time restriction of six months that section 29 sets, but the onus of proving that the disposition was made with the intention to prefer a specific creditor lies with the liquidator. As I indicated above, most securitisation transactions are not entered into with an intention to prefer.

If it is possible to prove fraud or collusion between the originator, the SPV and possibly other role-players in the securitisation transaction, section 31 might be available to impeach the disposition,<sup>121</sup> or alternatively, the common law *actio Pauliana*.<sup>122</sup>

The *actio Pauliana* will only be an option if it is possible to prove that the SPV colluded in defrauding the creditors of the originator, which in this context means that the object of the disposition was to give a particular creditor an unfair advantage

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<sup>118</sup> See par 8.2.2.

<sup>119</sup> See par 8.2.2.1.1.

<sup>120</sup> See par 8.2.2.1.2.

<sup>121</sup> See par 8.2.4.

<sup>122</sup> See par 8.4.



above the other creditors of the debtor. I explain above that proof of such intent in the context of securitisation is unlikely. However, since a successful application in terms of the *actio Pauliana* will not be subject to section 33(2) of the Act, it is uncertain what the effect of this order will be in regard to the rights of third parties, especially the investors of the SPV.

Section 33(2) of the Act provides that an order in terms of section 26, 29, 30 or 31 may not affect the rights of third parties who received property in good faith and for value.<sup>123</sup> I argue that the investors in the SPV will resort under this category of persons. The courts will have difficulty in making any order for impeachment of a disposition that will not have the effect of prejudicing the rights of the investors. I therefore conclude that even when there is proof of fraud or collusion it will be difficult to obtain an order for impeachment.

I considered the possible applicability of the notice requirements of section 34 to a securitisation transaction.<sup>124</sup> I came to the conclusion that many originators will not qualify as ‘traders’ in terms of this section and will therefore not have to comply with this requirement. However, if an originator is a trader in terms of its normal business operations I submit that claims resulting from these trading activities will resort under the business of the trader. The transfer of these claims in terms of a securitisation transaction will consequently be a transfer of part of the businesses of that trader.

The notice requirement of section 34 will only be avoided if the trader can prove that it is part of its ordinary course of business to transfer assets by way of securitisation. I cannot foresee that many traders will be successful with such an argument. Consequently, securitisations undertaken by originators that qualify as “traders” in terms of the section 34 should comply with the notice requirements of that section. This unfortunately implies that every liquidated liability of the trader in connection with the business, which would become due at some future date, will fall due immediately if the creditor demands payment of the debt.

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<sup>123</sup> See par 8.2.5.

<sup>124</sup> See par 8.3.



## CHAPTER 9

# SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

In this thesis I considered aspects of traditional securitisation in South African law. The thesis can be divided into three main sections, namely (1) the structure of a traditional securitisation scheme, (2) the regulatory aspects relevant to traditional securitisation in South African law, and (3) the true sale requirement and insolvency-remoteness. I also considered each of these aspects in American law and in English law. Although the structures of securitisation schemes are based on those used in these two jurisdictions, I showed that the law with regard to the transfer of assets to the SPV as well as the law of security in South Africa differ from the law in these jurisdictions. Such differences must be borne in mind when securitisation schemes are structured in South Africa. In this chapter I summarise my conclusions on each of these main sections with recommendations immediately following.

### 9.1 STRUCTURE OF SECURITISATION SCHEME

Traditional securitisation is the pooling of a homogeneous group of income-producing assets, the sale of these assets by the original holder (originator) to an insolvency-remote third party (a special purpose vehicle or SPV) and the issue by the special purpose vehicle of marketable securities (commercial paper or other debt instruments) to finance the purchase of the assets.<sup>1</sup> The transferred assets provide the cash flow to service the obligations under the issued securities. The transferred assets, which I assumed in this discussion to be claims, are collected by a servicer at a fee. This function is often retained by the originator. The transferred assets further serve as security for the obligations of the SPV towards its investors. Usually a trustee for debenture-holders or a security SPV holds this security on behalf of the investors. The transferred assets and the structure of the securitisation scheme are rated by a rating agency at a fee. Depending on the rating that the originator aims to achieve, the rating agency may recommend certain credit enhancements. These credit enhancements may be internal, that is, from the originator, or external from third parties. The structure of the scheme aims to reduce as far as possible the risk of default of the SPV on its duties towards the investors.

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<sup>1</sup> Paragraph 2.1.

The advantages that securitisation offers in comparison to other forms of financing depend mainly on two aspects,<sup>2</sup> namely

- 1 Checks and balances built into the structuring of the scheme in order to ensure that investors are protected. These checks and balances include the limitation of the capacity and powers of the SPV, a rating of the securities by a reputable rating agency, credit enhancement and security in favour of a trustee for debenture-holders or a security SPV. If executed with care, these checks and balances should be enough to protect the interests of investors without the need for substantial legislative regulation.<sup>3</sup>
- 2 The sale of the assets to the SPV, so that the assets are permanently removed from the estate of the originator outside of the reach of its creditors or its liquidator.<sup>4</sup>

### 9.1.1 Rating agencies

The rating agency plays a particularly important role from the start of the transaction in evaluating every component and providing opinions on how to maximise the potential of the scheme to give optimal safeguards to the investors.<sup>5</sup> At least one aspect of securitisation schemes in South Africa, namely the use of a security SPV rather than a trustee for debenture-holders, has been the result of the influence of rating agencies. Rating agencies are further important, because the investment mandates of most institutional investors require that they only invest in securities with a specific minimum rating. This means that the safety of the investment of the life savings of many ordinary people rests on the integrity of the rating provided by these agencies.

I concluded that extensive regulation of rating agencies is not necessary. I believe that liability can follow in terms of the common law if rating agencies provide an inaccurate rating because of a negligent performance of their duties. However, I believe that South Africa can benefit from a system of certification of rating agencies to indicate the quality of the ratings of a particular agency.<sup>6</sup>

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<sup>2</sup> For a discussion of the advantages of securitisation, see par 2.2.

<sup>3</sup> The legislative aspects relevant to traditional securitisation in South African law are summarised and discussed in par 9.2 below.

<sup>4</sup> This aspect is discussed in par 9.3 below.

<sup>5</sup> Paragraph 2.6.

<sup>6</sup> See the recommendations below.

### 9.1.2 Security SPV

In most respects the structure of a typical traditional securitisation scheme in South Africa is similar to the structure used in the United States of America and in England. However, the structure of the vehicle used to hold security on behalf of the investors in the scheme differs substantially from that used in other jurisdictions. Instead of making use of a typical trustee for debenture-holders, security is held on behalf of investors by a second company incorporated for this purpose, to which I refer as the security SPV.<sup>7</sup>

The use of a security SPV in South African securitisation schemes is a consequence of the insistence by rating agencies that transaction creditors involved in the securitisation scheme must agree not to institute applications for winding-up of the SPV before two years after the final claims of the investors have been paid. These non-petition clauses reduce the risk of the insolvency of the SPV. However, transaction creditors are not willing to enter into such agreements, unless the SPV grants security in their favour over the assets of the SPV.

There is uncertainty in South African law about whether a debenture trust could provide security through the same trust to beneficiaries other than the debenture-holders. This uncertainty is created by the fact that section 117 of the Companies Act<sup>8</sup> that provides for the trust for debenture-holders makes no mention of other creditors of the company.

I concluded that sections 117 to 121 of the Companies Act that deal with security for debentures are superfluous and only lead to uncertainty and inefficiency.<sup>9</sup> The uncertainty lies in the fact that only debenture-holders are mentioned, when it ought to be possible to grant security in favour of a trustee for any creditor of a company. The inefficiency lies in the fact that neither the Deeds Registries Act<sup>10</sup> nor the Trust Property Control Act<sup>11</sup> makes any mention of the provisions of the Companies Act that deal with trusts for debenture-holders.

<sup>7</sup> Paragraph 2.8.2.1.

<sup>8</sup> 61 of 1973.

<sup>9</sup> Paragraph 2.8.2.2.1

<sup>10</sup> 47 of 1937.

<sup>11</sup> 57 of 1988.

The security SPV binds itself as guarantor for the duties of the issuer SPV towards its creditors. When the issuer SPV defaults in respect of its duties, the security SPV will be liable to fulfil those duties. The issuer SPV indemnifies the security SPV in the event that the guarantee becomes effective. The duties in terms of the indemnity are secured by a pledge of the shares in the issuer SPV in favour of the security SPV by the shareholders. The duties are further secured by way of a fiduciary security cession of the assets of the issuer SPV. The liability of the security SPV towards the creditors in terms of the guarantee is limited to the amount recovered from the issuer SPV in terms of the indemnity.

When the guarantee is called up the security SPV becomes the debtor of the debenture-holders and the other transaction creditors. I have two concerns regarding the absence of a trustee for debenture-holders under these circumstances. First, the security SPV will have to call up its own guarantee, because it serves not only as guarantor but also as monitor of the issuer SPV. Second, after the security SPV becomes liable under the guarantee there will be no person to guard over the interests of the debenture-holders collectively. At this stage there will be no one to monitor the security SPV's obligations under the guarantee for the debenture-holders.

I concluded that it would be beneficial to the interests of debenture-holders to make use of a trust for debenture-holders to represent their interests in a security SPV. The trustee for debenture-holders could then monitor the security SPV when the guarantee is called up. The trustee can institute proceedings on behalf of the debenture-holders before the guarantee is called up or when the true sale of the assets is argued before a court during the liquidation of the originator.

### 9.1.3 Trust for debenture-holders

I considered whether a trust for debenture-holders should take the form of agency,<sup>12</sup> a *bewind* trust<sup>13</sup> or a true trust.<sup>14</sup> When considered against the benefits that one wants to gain by using a trust for debenture-holders,<sup>15</sup> I concluded that the true trust construction of a trust for debenture-holders best achieves these benefits.

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<sup>12</sup> Paragraph 2.8.2.2.1.

<sup>13</sup> Paragraph 2.8.2.2.2.3.

<sup>14</sup> Paragraph 2.8.2.2.2.4.

<sup>15</sup> Paragraph 2.8.

If the debenture trust takes the form of an agency, it will not be possible to register security in favour of the ‘trustee’, because section 54 of the Deeds Registries Act<sup>16</sup> prohibits the registration of security in the name of an agent.<sup>17</sup> Consequently, the security will have to be registered in favour of the individual debenture-holders. Priority is determined by the date of registration in the case of mortgages and special notarial bonds. It will therefore be impossible to give the debenture-holders equal priority. Registration of security rights for potentially thousands of debenture-holders is impractical from a financial and administrative point of view. Registration in the names of the individual debenture-holders further implies that each transfer of the debenture would mean that the registered bond must be ceded. This may severely restrict the transferability of the debentures. The agency construction will therefore only work if there are relatively few debenture-holders who do not foresee the transfer of the debentures. This will obviously not be advantageous for a securitisation scheme.

Under the trust construction of the debenture trust, compliance with the Trust Property Control Act<sup>18</sup> is necessary. The applicability of the Act brings a measure of protection of the interests of the debenture-holders. The Act separates the trust property from the personal estate of the trustee. It also requires proper bookkeeping and requires that trust property be clearly registered as such. It makes the trustee accountable to the Master when called upon to do so.

Owing to the accessory nature of most security rights, both the principal debt and the security rights must vest in the same person.<sup>19</sup> This leads to the conclusion that under the trust construction of the debenture trust the principal debts and the security must either vest in the debenture-holders or in the trustee. The principal debt cannot vest in the debenture-holders but the security right in the trustee.

I suggested that the trust for debenture-holders could take the form of a *bewind* trust if a second SPV is introduced into the structure. This second SPV will take up all the issued debentures and transfer them to the debenture-holders as beneficiaries under the trust. The principal debt and the security rights will vest in the debenture-holders. However, control will vest in the trustee. I concluded that this structure is not

<sup>16</sup> 47 of 1937.

<sup>17</sup> Paragraph 2.8.2.2.1.

<sup>18</sup> 57 of 1988.

<sup>19</sup> Paragraph 2.8.2.2.2.

recommended, because as in the case of the agency construction, the security will have to be registered in the names of the individual debenture-holders.

In the true trust construction of the trust for debenture-holders, the debenture-holders cede their claims to the trustee as a condition of the debenture. The debenture-holders themselves act as founders of the trust and serve as its beneficiaries. Security may be granted directly in favour of the trustee. Other transaction creditors could cede their claims to the trustee in a similar manner, in which case the trustee could hold the security in their favour also. Since the trustee holds the security on behalf of the debenture-holders as beneficiaries, there is no need to re-register the security when the debentures are sold. The new debenture-holder will simply become the new beneficiary under the trust.

#### **9.1.4 Form of security in favour of security SPV**

Security by means of claims can be created by way of a general notarial bond, a pledge of claims or a fiduciary security cession.

There are several reasons why the general notarial bond is a weak form of security:<sup>20</sup>

- An unperfected general notarial bond does not give its holder real security, but only a statutory preference on the insolvency of the debtor.
- Before perfection the debtor may alienate the encumbered property, may create real security over those assets in priority to the general notarial bondholder and the debtor's creditors may attach the encumbered property.
- The hypothecation of a shop is, in my opinion, a form of special notarial bond that cannot comply with the specificity requirements of the Security by Means of Movable Property Act.<sup>21</sup> The decision of the Appellate Division in *Cooper NO v Die Meester*<sup>22</sup> implies that the holder of such a bond does not enjoy a preference over the other creditors of the debtor. Security over the stock-in-trade cannot be created under the Security by Means of Movable Property Act, because of its fluctuating nature which means that it cannot be described in the manner required by the Act. Stock-in-trade will fall under a general notarial bond. I further

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<sup>20</sup> Paragraph 5.4.2.

<sup>21</sup> 57 of 1993.

<sup>22</sup> 1992 (3) SA 60 (A).



concluded that even if third parties had actual knowledge of a general notarial bond over the stock-in-trade, they would be able to assume that it was the intention of the parties to the security agreement that the stock-in-trade could be alienated.<sup>23</sup>

- The perfection of general notarial bonds in terms of current South African law gives rise to unsatisfactory results:<sup>24</sup>
  - Only the first general notarial bondholder that perfects his security will have a secured claim against the estate of the debtor.
  - The other general notarial bondholders will always only be preferred over the unsecured creditors of the debtor's insolvent estate, because only one person can take physical control of a security object.
  - This is the position regardless of the fact that the other general notarial bonds might have been registered before the one that was perfected.
  - Bondholders cannot effectively strengthen their position by means of contractual clauses to prevent later security over the assets, because third parties are not deemed to be aware of such clauses.
  - It makes no difference whether the other bondholders were only fractionally later than the successful bondholder in their attempts to perfect.
  - If the provisional winding-up of the debtor followed an interim order for attachment in terms of a perfection clause, this alone will not be enough to keep the court from confirming the attachment order on the return date.

I concluded that the legislature will have to reconsider the perfection of general notarial bonds in order to overcome the impossibility of more than one creditor to take control of the assets encumbered by a general notarial bond.

A shortcoming in the Deed Registries Act<sup>25</sup> is that its definition of 'person' does not include a trust for the registration of interests in movable property.<sup>26</sup> The implication of this is that the registration of notarial bonds, both special and general, in favour of a trustee is strictly speaking not possible in accordance with the Act. The fact that the Registrar of Deeds allows such registration in practice does not change

<sup>23</sup> Paragraph 5.4.2.2.

<sup>24</sup> Paragraph 5.4.2.4.

<sup>25</sup> 47 of 1937.

<sup>26</sup> Paragraph 5.5.1.

this position. One of the methods by which security over claims can be granted in South African law is through a general notarial bond. If the validity of the registration of general notarial bonds is in question, the use of general notarial bonds during securitisation will lead to a lower rating of the securities issued by the SPV.

When considering which form of security to use, it is important to avoid any necessity of having to give notice to the debtors about the scheme. Notice may cause uncertainty and carries administrative and cost implications. The originator will often want to maintain a business relationship with its debtors and would not want the debtors to make payments to a third party. Since it is still uncertain in South African law whether notice to debtors is necessary to perfect a pledge of claims,<sup>27</sup> a fiduciary security cession of claims is in my opinion the most certain security over claims and ought to receive better ratings from rating agencies.<sup>28</sup>

## **9.2 REGULATORY CONSIDERATIONS FOR TRADITIONAL SECURITISATION**

There is no consolidated statutory regulation of securitisation in South Africa. This is also the case in the United States of America and in England. I do not believe that there should be such regulation, because securitisation as a form of financing is still evolving in many aspects, such as the types of assets used and the securities issued during the transaction. Extensive regulation might stifle such innovation. Furthermore, a securitisation scheme already contains various measures to reduce risk to investors and to monitor the servicing of the assets of the SPV. In other words, securitisation is self-regulatory.

However, there are several pieces of legislation that impact on securitisation:

### **9.2.1 Securitisation Notice, 2008**

Securitisation Notice, 2008 is the most important regulation with regard to securitisation in South Africa.<sup>29</sup> An SPV that issues securities to the public must comply with the Notice to be exempted from falling under the definition of ‘the business of a bank’ in terms of the Banks Act.<sup>30</sup> Although the Notice is only

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<sup>27</sup> Paragraphs 5.4.3.1 and 5.5.2.

<sup>28</sup> Paragraphs 5.4.3.2 and 5.5.3.

<sup>29</sup> Paragraph 6.2.5.

<sup>30</sup> 94 of 1990.

applicable to SPVs that issue securities to the public, the Notice does provide guidance as to what the legislature regards as best practice and is therefore important when considering securitisation in general.

The current Securitisation Notice is the fourth of its kind. Initially only banks could act as originators of securitisation schemes.<sup>31</sup> Furthermore, the provisions of Commercial Paper Notice, 1994 only exempted issues of commercial paper issued or transferred in denominations equal to or greater than R1 million and by a company that had net assets exceeding R100 million in the 18 months preceding the issue from falling under the definition of ‘the business of a bank’.<sup>32</sup> These restrictions did not apply if the securities were listed on a recognised financial exchange, or were endorsed by a bank, or were issued for longer than five years, or were issued or backed by Central Government. This meant that even if originators other than banks could use securitisation during this time, only large issues of securities by an SPV could qualify for exemption in terms of Commercial Paper Notice, 1994.

Securitisation Notice, 2001 was the first instrument that really opened the possibility to non-bank originators, as well as to smaller originators, to make use of securitisation.<sup>33</sup> It further contained its own requirements for the issue of commercial paper by an SPV, which replaced the requirements of Commercial Paper Notice, 1994.

Securitisation Notice, 2004 mainly introduced the regulation of synthetic securitisation schemes. It also improved a few ambiguous provisions of the previous Notice with regard to traditional securitisation.

Securitisation Notice, 2008 does not materially alter Securitisation Notice, 2004, but rather adds certain matters that were not addressed previously. The Notice contains a paragraph devoted solely to the aspect of continued control of the assets by the originator and its impact on insolvency-remoteness. The transferor may not maintain any effective or indirect control over the assets after transfer to the SPV. The assets and the benefits flowing from those assets must be transferred to the SPV in such a manner that they are beyond the reach of the transferor (originator) even in the event of its insolvency. The transferor is deemed to have maintained effective control

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<sup>31</sup> Paragraph 6.2.1.

<sup>32</sup> Paragraph 6.2.2.

<sup>33</sup> Paragraph 6.2.3.

over the transferred assets when the transferor is able to repurchase the assets from the SPV in order to realise their benefits or if it is obligated to retain the risk relating to the transferred assets. The continued servicing of the assets by the transferor is expressly excluded as a form of indirect control of the assets.

The new provisions of Securitisation Notice, 2008 seem to indicate that there is an increased awareness on the side of regulators that continued control by the originator of the assets after transfer to the SPV may pose problems to the insolvency-remoteness of the scheme. Most of the provisions aim to ensure that the originator's role after the transfer is limited and well described, so that the originator cannot increase its involvement if the transferred assets do not perform as expected.

However, the Notice is flawed in one material aspect. This flaw inadvertently negates the purpose of separation of the originator and the SPV. The Schedule to Securitisation Notice, paragraph 4(2)(a) contains the following provision:

The transfer of the assets to or acquisition of assets by a special-purpose institution shall totally divest the transferring institution and all its associated companies and, when the transferring institution is a bank, divest any other institution within the banking group of which such a bank is a member, of all rights *and obligations* originating from the underlying transactions and all risks in connection with the assets transferred or acquired (my emphasis).

The Notice further foresees the possibility of securitising an “undrawn commitment” to lend money to a borrower.<sup>34</sup> In such a case the only possibilities for the transfer of the undrawn commitment allowed by the Notice are novation, assignment or any other means specified in writing by the Registrar.

I concluded that these provisions of the Securitisation Notice, 2008, implies that the type of transfer agreement that will comply with the requirements of the exemption notice is delegation. However, in my opinion, delegation is not the most suited method by which to transfer the assets to the SPV.<sup>35</sup>

Even if the duties arising out of agreements with the debtors are transferred to the SPV as foreseen by the Notice, the SPV will not be in a position to actively participate in the fulfilment of those duties. An SPV has, per definition, only a limited main objective, namely to raise money from the public, backed by the assets transferred to it by the originator. It does not have capital available to meet lending obligations of the type that Securitisation Notice foresees, nor does it maintain the

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<sup>34</sup> Schedule, par 4(2)(i).

<sup>35</sup> See also par 9.3.

personnel to administer and manage an ongoing business relationship with a debtor. Nor will it suffice to use the originator/servicer to administer such a relationship, because the definition of ‘servicing agent’ in the Notice only covers the collection of amounts due and does not make provision for the administration of ongoing lending activities. The retention of such functions by the originator would, in my opinion, amount to something more than the servicing of the amounts due.

Paragraph 4(2)(j) of the Schedule of Securitisation Notice, 2008 is, in my opinion, contradictory when the objective of accomplishing a true sale is borne in mind:

The agreement between the institution transferring the assets in terms of a traditional securitisation scheme and the special-purpose institution shall be such that, in the event of the terms of an underlying transaction being amended, the special-purpose institution, and not the transferring institution, or any of the transferring institution’s associated companies or, when the transferring institution is a bank, any other institution within the banking group of which such a bank is a member will be subject to the terms so amended.

Again this paragraph implies that the assets are transferred to the SPV by way of delegation. The amendment of the underlying agreement to the effect that the SPV and not the originator is bound, assumes that the debtor consented to a substitution of lenders. Furthermore, although it does not expressly state this, the paragraph suggests that the debtor will continue to deal with the originator. If this was not the case and the debtor dealt directly with the SPV, the amendment of the underlying transaction would be a new agreement between the debtor and the SPV and the paragraph would become superfluous. It seems then that the paragraph foresees that the debtor will amend the terms of the underlying agreement through negotiation with the originator, but that the SPV will be bound by the terms of the varied agreement.

I concluded that this paragraph grants the originator blanket consent to act on behalf of the SPV in the variation of the terms of the underlying transaction. Despite the efforts of Securitisation Notice to separate the corporate governance of the SPV from the control of the originator,<sup>36</sup> this paragraph allows that acts by the originator will bind the SPV. I doubt whether this was the intention.

## 9.2.2 Banks Act 94 of 1990

An SPV that does not comply with the provisions of Securitisation Notice, 2008 when it issues securities to the general public, will fall under the provisions of Chapter VIII

<sup>36</sup> Paragraph 6.2.3 and 6.2.4.

of the Banks Act.<sup>37</sup> These provisions essentially aim to reverse the transactions that occurred while the transgressing institution was not registered as a bank. The Registrar of Banks can appoint a manager to oversee this process and extensive powers are given to the manager in this respect.

Both the SPV and the originator will be affected if such a manager is appointed. The SPV would have used the money raised from the issue of securities to pay for the transfer of the claims. The manager will have the authority to follow that money to the originator and to reclaim it in order to repay the investors. It is doubtful whether it will be possible to reverse a securitisation scheme without loss to the investors in the scheme. Also, the originator will suffer severe reputational loss under these circumstances.

The Banks Amendment Act<sup>38</sup> amended Chapter VIII, dealing with the management of an institution that did not comply with the exemption notice.<sup>39</sup> In future the manager must report on the solvency of the scheme on his appointment. The Registrar is given extensive powers under the Act to prevent the commencement of liquidation proceedings and to stay all legal action against the institution under management. When the institution is an SPV under a securitisation scheme, it will, in my opinion, be in the best interests of the investors in the scheme if the Registrar consults with the trustee for debenture-holders before taking action in terms of Chapter VIII. The Registrar could further consider appointing the trustee as manager when the provisions of Chapter VIII take effect.

### **9.2.3 National Credit Act 34 of 2005**

In my opinion, proper consumer protection measures will aid securitisation in the long run, because the default patterns of debtors may become more predictable.<sup>40</sup> Better predictability of such default patterns will, in turn, enhance the efficiency of the structuring of the securitisation scheme. Rating agencies will take special note of the provisions of the Act when they rate the quality of the claims ceded to the SPV.

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<sup>37</sup> 94 of 1990. See par 6.3.

<sup>38</sup> 20 of 2007.

<sup>39</sup> Paragraph 6.3.1.

<sup>40</sup> Paragraph 6.4.

The issuer SPV will need to register as a credit provider in terms of the Act, because it will acquire the rights of a credit provider.<sup>41</sup> The originator will usually be a credit provider in terms of section 1 of the Act.

However, it is less clear whether the trustee for debenture-holders or the security SPV will also need to register as a credit provider. Since non-compliance with the registration requirement will leave the underlying credit agreements to be classified as unlawful agreements and void in terms of section 89, it is safest to register the trustee for debenture-holders or security SPV as a credit provider.

From a theoretical point of view it is only necessary for the trustee for debenture-holders or security SPV to immediately register as a credit provider if the securities issued by the SPV are secured by way of fiduciary security cession. In this form of security the claims will be ceded to the trustee for debenture-holders or security SPV, who then acquires the rights of a credit provider. The SPV does not retain these rights when this form of security is used, but only has a reversionary interest that the remaining claims will be receded to it after it had complied with its obligations in terms of the issued securities.

If a pledge of claims is used as a form of security, the duty to register as a credit provider will only arise after default of the SPV. During a pledge of claims the entitlement to realise the claim is transferred to the pledgee, but this entitlement may only be exercised by the pledgee after default by the pledgor. The claim itself remains in the estate of the pledgor. The pledgee will not acquire the rights of a credit provider before it is entitled to realise the claims in terms of the pledge. Furthermore, if the securitisation scheme goes as planned this entitlement will not become effective at all, which would make the registration of the trustee or security SPV as credit provider superfluous.

If a general notarial bond is used as security, the trustee or security SPV will only acquire the rights of a credit provider after perfection of the bond, which in the case of claims will be after notice is given to debtors. Until then the SPV will continue to collect the claims for its own account through its appointed servicer. The trustee or security SPV will not have acquired the rights of a credit provider as stipulated in the Act.

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<sup>41</sup> Paragraph 6.4.3.

### 9.2.4 Companies Act 61 of 1973

It must be determined whether a particular securitisation will constitute the disposal of the whole or a substantial part of the assets or the undertaking of the originator.<sup>42</sup> If so, a special resolution by the members of the originator will be necessary to effect the scheme. The scheme will then also be an affected transaction that will fall under the supervision of the Securities Regulation Panel on Take-Overs and Mergers.<sup>43</sup>

Conflicts of interest may arise where a director of the originator has interests in the SPV or in one of the other parties involved with the scheme.<sup>44</sup> The board of directors of the originator must be careful in this regard.

Securitisation also places added duties on the shoulders of the originator's company secretary,<sup>45</sup> if appointed, and on the auditor of the originator and SPV.<sup>46</sup> The SPV's auditor must certify that there has been compliance with the requirements of Securitisation Notice, 2008.

The SPV must issue a prospectus if its securities will be offered to the public.<sup>47</sup>

### 9.2.5 Companies Bill 61 of 2008

The Companies Bill does away with the distinction between the memorandum and articles of association of a company. Instead, it prescribes one constitutive document, namely the memorandum of incorporation. At present the memorandum of association of an SPV limits its capacity to transactions concerned with the securitisation scheme and matters incidental thereto.<sup>48</sup> Such a limitation of the capacity of the SPV is also a requirement of Securitisation Notice, 2008<sup>49</sup> and is important for rating agencies when they consider the rating of the securities issued by the SPV.<sup>50</sup> I concluded that the Companies Bill leaves enough flexibility for the inclusion of restrictions in the memorandum of incorporation of an SPV to limit its

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<sup>42</sup> Paragraph 6.5.1.1.

<sup>43</sup> Paragraph 6.5.1.2.

<sup>44</sup> Paragraph 6.5.1.3.

<sup>45</sup> Paragraph 6.5.1.4.

<sup>46</sup> Paragraphs 6.5.1.5 and 6.5.2.2.

<sup>47</sup> Paragraph 6.5.2.1.

<sup>48</sup> Paragraph 2.3.3.

<sup>49</sup> Paragraph 6.2.5.

<sup>50</sup> Paragraph 2.6.1.



capacity and the powers of its directors to act outside such capacity.<sup>51</sup> The potential for a downgraded rating and non-compliance with Securitisation Notice, 2008 will urge shareholders and directors of an SPV to uphold the limitations on the powers and capacity of the SPV.

The Bill still defines the disposal of the whole or a substantial part of the assets of a company as an affected transaction.<sup>52</sup> It further provides shareholder protection by requiring court sanction if more than 15 per cent of shareholders voted against the disposal and any shareholder who voted against the resolution applies for the court's review of the transaction. There is also a procedure in the Bill whereby a shareholder who was against the adoption of the resolution, may notify the company of his objection so that the company can purchase his shares at a fair market value. These provisions effectively leave the protection of minority shareholders, where a disposal of the assets or undertaking of a company is proposed, in the hands of the court. It remains unclear, as is the case under the current inclusion of section 228 transactions under the definition of an affected transaction, why these provisions are included in the sphere of securities regulation.

### **9.2.6 Collective Investment Schemes Control Act 45 of 2002**

I considered whether a securitisation scheme could be construed to be a collective investment scheme within the meaning of the Collective Investment Schemes Control Act.<sup>53</sup> Securitisation schemes are not specifically excluded from the operation of the Act. Furthermore, the definition of 'collective investment scheme' provided in the Act is so wide that it could include a securitisation scheme.

In the United States of America and in England the possible application to securitisation schemes of the regulatory framework for collective investment schemes is acknowledged.<sup>54</sup> Compliance with these regulations is costly and time consuming. Consequently SPVs, and in some cases also the originators, usually apply for exemption from compliance with these provisions. Alternatively, they structure the scheme in such a manner that it will fall under one of the exemptions of the applicable legislation and therefore will not be construed as a collective investment scheme.

<sup>51</sup> Paragraphs 6.6.1 and 6.6.2.

<sup>52</sup> Paragraph 6.6.4.

<sup>53</sup> 45 of 2002. See par 6.8.

<sup>54</sup> Paragraphs 3.3.1.1 and 4.3.1.1.

There are differences between a typical collective investment scheme and a typical securitisation scheme. The managers of a collective investment scheme buy *and sell* securities or property on a regular basis. Whereas the SPV issues securities to fund the acquisition of assets from the originator, the manager of a collective investment scheme needs capital of its own in order to initiate the scheme. There are minimum capital requirements for managers of collective investment schemes.

The duties of the custodian of a collective investment scheme differ from those of a trustee for investors during securitisation. The custodian is directly responsible for the administration of the trade in participatory interests in the collective investment scheme. The custodian is obliged to follow the instructions of the manager, unless they are inconsistent with the provisions of the Act or with the trust deed. It follows that the custodian does not truly function independently from the manager, although it has certain supervisory functions with regard to the manager.

Most importantly, the custodian does not hold the assets as security for the participations of the investors. Rather, the custodian becomes the owner of the assets and the rights of the investors are those of beneficiaries in a trust. The custodian indemnifies both the manager and the investors against any loss of money or damage to assets in its custody caused by its wilful or negligent act or omission, which explains the high capital maintenance requirements set for custodians.

I concluded that there are situations where a securitisation could fall under the definition of a collective investment scheme. This will be the case where the SPV issues securities to the public and the trustee for debenture-holders falls under the true trust construction, coupled with a fiduciary security cession of the assets. The investors will then be beneficiaries under a trust arrangement, with a participatory interest in the income generated by the assets.

### **9.2.7 Debt Collectors Act 114 of 1998**

I concluded that the servicer during a securitisation scheme will have to register as a debt collector in terms of the Debt Collectors Act.<sup>55</sup> The Act provides that amounts collected by a debt collector and deposited in the separate trust account that it must maintain for such purposes, do not form part of his estate and cannot be attached by his creditors. This provides a measure of protection to the SPV and to its investors.

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<sup>55</sup> 114 of 1998. See par 6.9.

### 9.3 TRUE SALE REQUIREMENT AND INSOLVENCY-REMOTENESS

The structure of the securitisation scheme and legislation applicable specifically to securitisation schemes, such as Securitisation Notice, 2008, aim to support a finding of a true sale of the assets by the originator to the SPV. After the sale of the assets, the assets must not be available to the creditors of the originator or to its liquidator on its subsequent insolvent liquidation.

#### 9.3.1 Sale as obligatory agreement between originator and SPV

The contract of sale provides the *justa causa* for the transfer agreement.<sup>56</sup> Owing to the operation of the abstract system of the transfer of rights in South African law, the invalidity of the contract of sale will not affect the transfer of the claims to the SPV. Should the SPV be declared insolvent under such circumstances, the investors will have secured claims against the insolvent estate of the SPV, whereas the originator will have a concurrent claim for the value of the transferred assets based on unjust enrichment.

#### 9.3.2 Transfer agreement between originator and SPV

The method of transfer currently implied by Securitisation Notice, 2008 is delegation. I concluded that cession lends itself much better to the objectives of a typical securitisation scheme. The reasons why I prefer cession to delegation are the following:<sup>57</sup>

- The debtor must not only be informed of the transfer during delegation, but must also give his consent for the substitution of his debtor with another party. Typically, one does not want to inform the debtor of the securitisation, because this will be a huge administrative task and may lead to uncertainty and concern on the part of the debtor. If the original agreement was in writing and contained a standard non-variation clause, the written agreement will have to be substituted for a new one. This has administrative, time-delay and cost implications.
- Delegation is a form of novation. Novation brings an end to a claim and the claim is replaced with a new one. During delegation the accessory security rights that

<sup>56</sup> Paragraphs 7.2.1, 7.2.2 and 7.2.2.2.2.

<sup>57</sup> Paragraph 7.2.2.1.

secured the original claim will cease to exist together with the claim. A new security right must be created with the creation of the new claim, for which the co-operation of the security grantor will be necessary. The new security right's priority will be determined according to the time when all the requirements for the creation of the new security right were met, and not with reference to the priority of the previous security right.

- The SPV may be unable to perform the duties transferred to it, because of the limitations stated in its objects clause.
- The duties transferred to the SPV may render the SPV vulnerable to insolvency, because it is not supposed to engage in business outside of the securitisation scheme. An example is the securitisation of operating leases of equipment. Such leases usually entail that the lessor, which will be the SPV after transfer, remains responsible for maintenance of the equipment.

Cession is effected in South African law by agreement alone. Notice to the debtor is not a requirement,<sup>58</sup> nor is the delivery of the document that evidences the right.<sup>59</sup>

### 9.3.3 Transfer of security rights

It is essential for the transfer of all security rights with an accessory nature that the principal debt is transferred to the SPV by way of cession and not through delegation. Delegation is a form of novation which leads to the termination of the claim. Accessory security rights will cease to exist when delegation is used during securitisation. Since delegation is implied by Securitisation Notice, 2008, it must be concluded that all accessory security rights held by the originator before transfer of the claims to the SPV cease to exist on transfer.

The SPV will have to enter into new agreements with the security grantors to obtain secured claims against the debtors. The priority of such security will not be determined with reference to the previous security, but will depend on the time of creation of the new security rights. The following comments assume that the claims are transferred to the SPV by means of cession.

I considered the requirements for the transfer of security rights that secure the claims that are sold to the SPV.<sup>60</sup> Suretyship follows the principal debt without the

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<sup>58</sup> Paragraph 7.2.2.2.3.

<sup>59</sup> Paragraph 7.2.2.2.1.

need for a separate agreement to transfer the security, unless this possibility is expressly excluded. The originator will be entitled to transfer claims it holds in terms of fiduciary security cession to the SPV, unless restricted in the agreement creating the right. If the claims are secured by way of a pledge of claims, the consent of the pledgor is necessary, but such consent can be given in the original security agreement.

In the case of real security rights, the transfer of the security to the SPV should not pose major difficulties to securitisation. The requirements for the transfer of such rights are a real agreement<sup>61</sup> and publicity of the transfer by means of registration or delivery. The Deeds Registries Act<sup>62</sup> makes provision for the registration of a transfer of mortgage bonds and notarial bonds. Consent for the transfer of the real security right can, in my opinion, be granted in the original security agreement, i.e. between the originator and the debtor.

#### 9.3.3.1 Transfer of covering bonds

The current requirement of Securitisation Notice, 2008 that the transfer of the assets must divest the originator of both rights and obligations leads to specific difficulties for the transfer of covering bonds.<sup>63</sup>

If the contract by which future advances to the debtor were agreed is terminated on the transfer to the SPV, the bond will change from a covering bond to a bond for a fixed amount and the transfer should not pose any problems.

It is possible in terms of section 52 of the Deeds Registries Act<sup>64</sup> to transfer a covering bond. However, section 52 foresees future advances by the cessionary of the principal debt, because the limit initially registered for the covering bond will continue to apply after the transfer of the bond. The SPV does not have the capacity or the capital to act as a credit provider in this manner.

It will usually not be the intention that the business relationship between the originator and the debtor should come to an end after the securitisation. The originator wants to cede the balance at a particular moment to the SPV, while retaining the possibility of future advances to the debtor by keeping the contract with the client in

<sup>60</sup> Paragraph 7.2.3.

<sup>61</sup> See ch 5 n 155 and ch 7 n 75.

<sup>62</sup> 47 of 1937.

<sup>63</sup> Paragraph 7.2.3.1.

<sup>64</sup> 47 of 1937.

tact. The credit institution will want to retain the bond to secure future claims against the debtor. However, the bond cannot be split to cover claims owed to two creditors, as this is prohibited by section 50(5) of the Deeds Registries Act. It would in effect be an illegal participation bond.

Furthermore, for policy reasons the legislative creation of the possibility of the splitting of a bond is not recommended. Even if the debtor consented in the original bond agreement to the transfer of the bond, the debtor probably did not foresee that such a transfer could be only partial and that the bond could be split in favour of more than one security holder.

If it were possible to cede the claims only to the SPV as they arise, the following arrangement would be recommended: the originator transfers the covering bond to the SPV and cedes the claims that arise under its business relationship with the debtor to the SPV as they arise. In other words, the claims as they arise are ceded to the SPV, but the originator remains liable for the duties under the original agreement with the debtor. Under such an arrangement the originator should be aware that it no longer has secured claims against the debtors whose covering bonds were ceded. Since it sells those claims to the SPV, the risk it takes by transferring the bond is small.

I concluded that such an arrangement is currently not allowed by Securitisation Notice, 2008. The principal debt comes to an end by virtue of the delegation agreement, which means that the accessory covering bond must also come to an end.

#### 9.3.3.2 Transfer of instalment sale agreements

All the requirements for the transfer of a real right, in this case ownership, will have to be complied with.<sup>65</sup> Of specific importance is the requirement that the thing must be delivered to the new owner. Most instalment sale agreements contain a clause to the effect that the purchaser will hold the sold item on behalf of the seller's cessionaries. It is my opinion that the purchaser will be held to such consent.

However, there is a potential problem if the purchaser sells the thing and gives up control in favour of the new purchaser. The new purchaser will not have entered into any agreement to hold the thing on behalf of the original owner and his cessionaries. There is case law to the effect that under these circumstances the original owner will not succeed in transferring ownership, because he will not be able to deliver the thing

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<sup>65</sup> Paragraph 7.2.3.4.

to the other party. Under these circumstances it will not be possible for the SPV to gain ownership in the sold items. The SPV will take the claims against the purchasers without any security.

If ownership is transferred to the SPV, the SPV will have the duty to pass ownership to the purchaser once full payment is received, by way of *traditio brevi manu*. The purchaser will have to consent to the transfer of such a duty, but such consent can be given in the original instalment sale agreement. Furthermore, the real agreement reached when the thing is delivered to the purchaser is enough to let ownership pass to the purchaser on fulfilment of the condition that full payment must be received. It is not necessary to enter into a new real agreement at the time when the final instalment is paid, nor is it necessary that a second form of delivery should take place at that time. This is the case even when the original agreement is transferred. The duty of the SPV to transfer ownership is therefore negligible.

#### 9.3.4 Transfer of future claims

The transfer of future claims is allowed in South African law.<sup>66</sup> However, there are certain unanswered questions about such a transfer. For instance, it is still not settled whether the claims first materialise in the estate of the cedent or whether they materialise in the estate of the cessionary directly. If the claims materialise in the estate of the cedent first, they will not pass to the cessionary if the cedent is insolvent at that time. I argued that this should not pose too much of a problem to securitisation in South Africa, since the securitisation of future claims will always be more risky. The scheme will therefore in its structure cater for the fact that the financial soundness of the originator still has some influence on the stability of the scheme.

#### 9.3.5 Relationship between SPV and servicer

The SPV (mandator) will enter into a contract of mandate with the servicer (mandatary) in terms of which the servicer will be obliged to collect the debts due to the SPV.<sup>67</sup> The agreement between the SPV and the servicer will determine whether this mandate results in agency, a mandate *in rem suam*, or a cession for collecting purposes.

<sup>66</sup> Paragraph 7.2.4.

<sup>67</sup> Paragraph 7.3.

If the servicer acts as an agent of the SPV it can collect claims on behalf of the SPV extra-judicially without informing the debtor of the cession of the claims. However, when the claims are collected judicially the originator will have to act on behalf of the SPV as its agent; otherwise the SPV will have no standing.<sup>68</sup>

I considered whether it is possible for the servicer to institute proceedings in his own name on behalf of the SPV. The servicer will then act on behalf of an undisclosed principal.<sup>69</sup> This will only be a possibility in theory where the servicer was the originator of the scheme, because the doctrine only has application where the debtor contracted with the agent only and was unaware of the principal. If the servicer is a third party, the debtor will of necessity be informed of the securitisation and of his new creditor.

A review of the case law showed that South African courts are generally opposed to the possibility of allowing an agent to sue in his own name. The courts are also opposed to extending the doctrine of the undisclosed principal to other areas of the law, such as procedural law. It is therefore safer to cede the claims to the servicer for collecting purposes if the servicer is to collect the claims in its own name.

If the servicer is not the originator of the scheme, the cession for collecting purposes is a new cession unrelated to the initial transfer of the claims to the SPV.<sup>70</sup> If the servicer was also the originator of the scheme, there are two possibilities. First, the cession could flow from a resolutive condition in the transfer agreement to the effect that on default by the debtor the agreement will be cancelled in respect of those individual claims by virtue of mutual agreement between the parties. Alternatively, the cession can be in terms of a clause in the servicing agreement to the effect that the claims will be ceded to the servicer when it needs to collect the claims judicially.

I am not in favour of a resolutive condition to provide the servicer with *locus standi* to collect the claims. It will not comply with paragraph 4(2)(b)(ii) of Securitisation Notice, 2008, which prohibits any duty on the side of the originator to retain the risk associated with the transferred assets. The assumption of risk by the originator that acts as servicer creates the impression that the transfer of the claims was not a true sale.

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<sup>68</sup> Paragraph 7.3.1.

<sup>69</sup> Paragraph 7.3.2.

<sup>70</sup> Paragraph 7.3.3.



Where the cession is a fresh cession for collecting purposes, the agreement to cede must be contained in the servicing agreement. The clause must read that under appropriate circumstances the servicer will inform the SPV of the need to institute legal action against the debtor, after which the SPV will cede the claim to the servicer for collecting purposes. The servicing agreement will be the obligatory agreement and the *causa* for the cession will be to collect the debt. The same agreement may contain the transfer agreement. The co-operation of the security SPV will be necessary to cede the claims to the servicer where the claims were given as security to the security SPV by way of a fiduciary security cession.

### 9.3.6 Simulated transactions

I concluded that the risk of recharacterisation of the transfer of the assets to the SPV as a loan is small.<sup>71</sup> The following considerations led me to this conclusion:

- The parties to the securitisation scheme truly intend to conclude a contract of sale and do their utmost to ensure that consequence. It is the only means by which they can achieve their ultimate economic objective, namely to gain financing at a better interest rate than the originator could obtain without the insulation of the assets from its enterprise.
- Owing to the limiting provisions of Securitisation Notice, 2008, traditional securitisation schemes in South Africa are prohibited from making use of repurchase agreements during the transaction. Bank originators may not replace non-performing assets with other similar, but performing assets. I am of the opinion that this also applies to the replacement of non-performing claims by non-bank originators, because it would mean that they retain some of the risk associated with the asset.
- Securitisation does not have the effect of converting a previously unsecured debt into a secured debt.
- In most of the case law that allowed for the recharacterisation of the assets transferred in terms of a purported sale, the assets were movable corporeals and not claims. Furthermore, the seller mostly remained in control of the transferred assets. The policy consideration behind finding such transactions simulated, lies in the lack of publicity of the transfer of ownership in terms of the sale. It is argued

<sup>71</sup> Paragraphs 7.4, 7.4.1 and 7.4.2.

that the creditors of the purported seller are potentially prejudiced, because they have no way of knowing that the assets no longer fall in the estate of the seller when they extend credit to him. I concluded that the same argument cannot be made in the case of securitisation. The originator is not impoverished by the sale of the assets to the SPV. The originator is paid for the transfer of the claims to the SPV, so that one asset (the claim) is replaced by another (money). Furthermore, claims are transferred by agreement alone and not publicised by delivery as is the case with corporeal movable property.

- The SPV becomes the legal holder (owner) of the claims without restriction. As explained above, cession for collecting purposes to the originator that will continue to act as servicer should be provided for in the servicing agreement and not through a resolutive condition in the transfer agreement.
- The SPV intends to make use of the transferred claims by using them as security for the issuing of debt securities. The SPV may even transfer the claims to the security SPV if it decides to make use of fiduciary security cession. It can therefore not be said that the SPV does not intend to make use of the transferred claims.

### **9.3.7 Impeachability of sale of assets on originator's insolvency**

The sale of the assets to the SPV will be a disposition in terms of the Insolvency Act.<sup>72</sup> Despite this, there is virtually no risk that the liquidator of an insolvent originator will be able to successfully impeach the transfer of the assets from the originator to the SPV in the absence of fraud.

Section 26 of the Insolvency Act, which provides for the impeachment of dispositions without value, is only available if no value was given in return for the disposition.<sup>73</sup> During a securitisation transaction the transfer of the assets will always be accompanied by payment, and financing by means of securitisation provides certain benefits that will also be regarded as value for purposes of this section. Arguments that the payment or other benefits received in return for the transfer of the assets to the SPV are inadequate, do not properly resort under section 26, but must be

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<sup>72</sup> 24 of 1936. See par 8.2.1.1.

<sup>73</sup> Paragraph 8.2.1.

raised in connection with a voidable preference in terms of section 29<sup>74</sup> or an undue preference in terms of section 30.<sup>75</sup>

It is a requirement of section 29 that the debtor must have been insolvent immediately after the disposition and of section 30 that the debtor was insolvent at the time of the disposition. It is most unlikely that an insolvent originator will be able to enter into a securitisation transaction. The affairs of the originator are scrutinised by rating agencies, lawyers who provide legal opinions to the rating agencies on the insolvency-remoteness of the originator and, if applicable, the securities exchange where the debt securities are to be listed.

However, even in the unlikely event that the originator is found to have been insolvent at the time of the transfer of the assets to the SPV, the chances of success under section 29 and 30 are limited. The SPV will be a creditor of the originator for purposes of section 29 and the transfer will have the effect of preferring the SPV above other creditors, which means that the liquidator will have satisfied the *prima facie* onus of proof required by the section. However, section 29 provides a defence to the creditor, namely that the transaction was in the ordinary course of the business of the debtor and that there was no intention to prefer.<sup>76</sup> This defence will usually be available to the SPV.

Securitisation is now an established form of financing. It cannot be contended that securitisation *per se* is extraordinary, although the terms of each transaction will have to be evaluated to determine whether a particular transaction fell outside the parameters of the ordinary course of business of the debtor. One securitisation scheme will often not be identical in its structure to others.

I evaluated the requirements of the ‘intention to prefer’ in terms of section 29 and concluded that the motivation of an originator to enter into a securitisation scheme will seldom amount to a primary or dominant intention to prefer the SPV to its other creditors.<sup>77</sup> The primary intention behind most securitisation schemes, which are scrutinised by several role-players apart from the originator, is financing and to obtain the benefits that arise from this particular method of financing.

<sup>74</sup> Paragraph 8.2.2.

<sup>75</sup> Paragraph 8.2.3.

<sup>76</sup> Paragraphs 8.2.2.1.1 and 8.2.2.1.2.

<sup>77</sup> Paragraph 8.2.2.1.2.

For the same reason, I do not foresee that a liquidator will be able to successfully rely on the provisions of section 30. This section does not carry the time restriction of six months that section 29 sets, but the liquidator must prove that the disposition was made with the intention to prefer a specific creditor. Most securitisation transactions are not entered into with such an intention.

If it is possible to prove fraud or collusion between the originator and the SPV, section 31 might be available to impeach the disposition,<sup>78</sup> or alternatively, the common law *actio Pauliana*.<sup>79</sup> The *actio Pauliana* will only be an option if it can be proven that the SPV colluded in defrauding the creditors of the originator, which in this context means that the object of the disposition was to give a particular creditor an unfair advantage above the other creditors of the debtor. As explained above, proof of such intent in the context of securitisation is unlikely. Since a successful application in terms of the *actio Pauliana* will not be subject to section 33(2) of the Act,<sup>80</sup> it is uncertain what the effect of this order will be with regard to the rights of third parties, especially the investors of the SPV.

### **9.3.8 Effect of impeachment on third parties**

Section 33(2) of the Insolvency Act<sup>81</sup> provides that an order in terms of section 26, 29, 30 or 31 may not affect the rights of third parties who received property in good faith and for value.<sup>82</sup> The investors in the SPV will resort under this category of persons. The courts will have difficulty in making any order for impeachment of a disposition that will not result in prejudicing the rights of the investors. I therefore concluded that even when there is proof of fraud or collusion it will be difficult to obtain an order for impeachment of the sale of the assets to the SPV.

### **9.3.9 Securitisation Notice and impeachment**

If the transfer of the assets to the SPV is impeached, the provisions of Chapter VIII of the Banks Act<sup>83</sup> become applicable. I base this conclusion on the fact that it is a

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<sup>78</sup> Paragraph 8.2.4.

<sup>79</sup> Paragraph 8.4.

<sup>80</sup> See par 9.3.8 below.

<sup>81</sup> 24 of 1936.

<sup>82</sup> Paragraph 8.2.5.

<sup>83</sup> 94 of 1990.

central requirement of Securitisation Notice, 2008 that the sale of the assets from the originator to the SPV will withstand legal scrutiny, also in the case of the originator's subsequent insolvency.

### **9.3.10 Notice requirements in terms of section 34 of Insolvency Act 24 of 1936**

I concluded that most originators will not qualify as 'traders' in terms of this section and therefore need not comply with the requirements of section 34. However, if an originator is a trader in terms of its normal business operations, claims resulting from these trading activities will resort under the business of the trader. The transfer of these claims in terms of a securitisation transaction will consequently be a transfer of part of the businesses of that trader.

The notice requirement of section 34 can only be avoided if the trader can prove that it is in the ordinary course of business to transfer assets by way of securitisation. I cannot foresee that many traders will be successful with such an argument. Consequently, securitisations undertaken by originators that qualify as 'traders' in terms of the section 34 should comply with the notice requirements of that section. It unfortunately implies that every liquidated liability of the trader in connection with the business, which would become due at some future date, will fall due immediately if the creditor demands payment of the debt.

## **9.4 RECOMMENDATIONS**

The following recommendations flow from the conclusions in this thesis:

### **9.4.1 Rating agencies**

I recommend that a certification of particular rating agencies as institutions that conform to sound methodology in their rating process should be considered. Such a certification must not aim to prescribe the methods and procedures followed by rating agencies, but must evaluate the methods and procedures already in use against specified criteria. The publication of methods and procedures to an independent certification authority, which may be an exchange that regularly deals with debt instruments, for instance the Bond Exchange of South Africa, would also encourage rating agencies to keep to those procedures and not to deviate from them without proper cause. This will lead to greater investor confidence in the ratings provided by

less established rating agencies and will ensure that the big three rating agencies keep to their publicised procedures.

#### **9.4.2 Security SPV and trustee for debenture-holders**

The provisions regarding security granted to a trustee for debenture-holders must be removed from the Companies Act<sup>84</sup> and should only be regulated by the Trust Property Control Act.<sup>85</sup> Section 43 of the Companies Bill<sup>86</sup> is not an improvement on the current position, because it still mentions the appointment of a trustee for debenture-holders without reference to the general applicability of the Trust Property Control Act. Section 43 therefore leaves the uncertainty about whether a trustee for debenture-holders could also hold security on behalf of persons other than the investors.

When use is made of a security SPV during securitisation, the interests of the investors should still be represented separately by a trustee for debenture-holders.

#### **9.4.3 Form of security in favour of security SPV**

The definition of 'person' in the Deeds Registries Act<sup>87</sup> must be amended so that security in movable property can vest in a trust.

#### **9.4.4 Perfection of general notarial bonds**

The current system of perfection of general notarial bonds is unsatisfactory. I suggest that a form of receivership of the movable property of a debtor, which is activated on an application by any general notarial bondholder to perfect his security, may address some of the problems regarding perfection. The receiver will take control of the assets and will manage the process on behalf of the general notarial bondholders. The receiver will owe the debtor the same duties as a pledgee. Secured status will then be granted to all general notarial bondholders on the appointment of the receiver and priority will be determined by the order of the registration of their bonds. All general notarial bonds must be granted the ability to be perfected in this manner and perfecting clauses should no longer be required.

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<sup>84</sup> 61 of 1973.

<sup>85</sup> 57 of 1988.

<sup>86</sup> 61 of 2008.

<sup>87</sup> 47 of 1937.

I submit that bondholders should not be allowed to alter their priority based solely on chance. If creditors are not satisfied with where they will lie in order of preference if the proposal above is implemented, they ought to refuse to extend credit. It will be unnecessary to include restrictive clauses to prevent the further extension of general notarial bonds over the assets, because such later bondholders will not be able to better their position in relation to the first bondholder by way of perfection. The position of the general notarial bondholders in relation to other secured creditors will remain unchanged, as will the entitlement of the debtor to grant further security over the encumbered assets. The order of priority must remain intact during the subsequent liquidation of the debtor.

I submit that such a system will lead to a far more satisfactory position for general notarial bondholders, although it will inevitably mean that there will be fewer assets available for distribution to preferent and unsecured creditors of the insolvent debtor. In the current system the amount that will be secured by a perfected general notarial bond will always be limited to one bondholder's claim. This concern can be addressed by capping the amount available for distribution to general notarial bondholders. In England in the event of the debtor's insolvency, a specified percentage of the amount available for distribution to the floating charge holders is kept back to be paid to unsecured creditors.<sup>88</sup>

#### 9.4.5 Securitisation Notice

I recommend that it must be possible in terms of the Securitisation Exemption Notice to transfer assets from the originator to the SPV by way of cession only, leaving any remaining duties with the originator. To achieve this, paragraph 4(2)(a) of the Schedule should be amended to read as follows:

The transfer of the assets to or acquisition of assets by a special-purpose institution shall totally divest the transferring institution and all its associated companies and, when the transferring institution is a bank, divest any other institution within the banking group of which such a bank is a member, of all rights ~~and obligations~~ originating from the underlying transactions and all risks in connection with the assets transferred.

<sup>88</sup> See ch 3 n 149.

No subsequent transactions by the SPV should bind the originator and no subsequent transactions by the originator should bind the SPV. Paragraph 4(2)(j) of the Schedule should be removed, because it creates the impression of continued involvement between the originator and the SPV.

I recommend that the Registrar of Banks should consult with the trustee for debenture-holders before taking action in terms of Chapter VIII of the Banks Act.<sup>89</sup> Paragraph 17(2) of the Schedule to Securitisation Notice, 2008 should be amended by adding the following:

- (b) If a trustee for debenture-holders was appointed under the scheme, the Registrar shall consult the trustee before he takes any action in terms of Chapter VIII.

#### **9.4.6 Exemption from the Collective Investment Schemes Control Act 45 of 2002**

The Registrar of Collective Investment Schemes should issue an exemption by way of notice to exclude securitisation schemes from the ambit of the Act.

Until such an exemption is issued, I recommend that the SPV obtains an exemption in terms of section 22, which provides that the Registrar may exempt a particular manager or a category of persons from any provisions of the Act on such conditions and to such an extent as he may determine. This might be time-consuming, but at least there will be certainty about whether the restrictions contained in the Act are applicable to the scheme. There will also be certainty about whether the Trust Property Control Act<sup>90</sup> is applicable to the scheme, because if the scheme is found to be a collective investment scheme, the application of that Act is specifically excluded and the provisions of the Financial Institutions (Protection of Funds) Act<sup>91</sup> apply.

#### **9.4.7 Transfer by way of cession**

As far as possible, the transfer of claims to the SPV should take the form of a cession of claims rather than of delegation. This is also essential if the SPV is to take transfer of accessory security rights of the transferred claims.

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<sup>89</sup> 94 of 1990.

<sup>90</sup> 57 of 1988.

<sup>91</sup> 28 of 2001.



#### 9.4.8 Relationship between SPV and servicer

For purposes of extra-judicial debt collecting, the servicer should act as the SPV's agent. When the debt must be collected judicially, the servicer can either act as the SPV's agent, or take cession of the claims for collecting purposes after which it may claim in its own name.

#### 9.4.9 Solvency of originator on transfer of assets

The SPV should obtain a statement by the auditors of the originator to the effect that the originator is solvent at the time of the securitisation transaction and that the transaction will not leave the originator insolvent.

#### 9.4.10 Section 34 of Insolvency Act 24 of 1936

The transfer of assets in the course of a traditional securitisation scheme should be excluded from the notice requirements of this section.

### 9.5 FINAL REMARKS

At the time of writing this conclusion it is apparent that the world economy is entering a recession. This will put strain on all debt capital markets, of which asset-backed securities form part. So far the insolvency-remoteness of SPVs has only been a point of discussion in academic circles, but it will probably soon be put to the test by liquidators in courts across the world.

The aim of this thesis is to recommend, from a legal point of view, the best practices in the structuring of the traditional securitisation scheme so that it can achieve the benefits of this form of financing.

However, behind the legal and economic issues surrounding securitisation stands a human aspect: large institutional investors usually invest in asset-backed securities. These institutional investors represent the interests of thousands of ordinary people, who rely on good returns on investment for their pensions and life insurance. The success, or failure, of traditional securitisation to withstand economic pressure, as well as the potential insolvency of its originator, has implications for all these people.

I am reminded of a piece of horticultural advice I received not long ago: I was told not to anchor a newly planted tree too tightly. Apparently, the stress of wind and the forced resistance that the tree must provide against it causes the tree to anchor itself

better. If one provides such anchorage artificially, the tree will fall over when the artificial supports are removed.

If securitisation is a tree, it grew tall in a very short time. If the stresses of the current economic conditions do not kill it, they are bound to make it stronger.

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*William Gaskell Group Ltd v Highley (Nos 1, 2, 3)* [1994] 1 BCLC 197 (Ch)

#### 10.4.4 Australia

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*Grove v Flavel* (1986) 43 SASR 410

*Hamilton v Hunter* (1983) 7 ACLR 295 (SC NSW)

*Kinsela v Russell Kinsela (Pty) Ltd* (1986) 10 ALR 395 SC (NSW)

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*Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1984) 8 ACLR 422 (SC NSW – CA)

*Spies v The Queen* (2000) 201 CLR 603 (HC of Australia)

*Stein v Saywell* (1969) 121 CLR 529 (HC of Australia)

*Torzillu Pty Ltd v Brynac Pty Ltd* (1983) 8 ACLR 52 (SC NSW)

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#### 10.4.5 New Zealand

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*Dewhirst v Citibank (In re Contractors Equip. Supply Co.)*, 861 F.2d 241 (9<sup>th</sup> Cir 1988)

*Drabkin v Midland-Ross Corp (In re Auto-Train Corp)*, 810 F 2d 270 (DC Cir 1987)

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*Federated Dept. Stores, Inc v Commissioner*, 51 T.C. 500 (1968), affirmed, 426 F.2d 417 (6<sup>th</sup> Cir. 1970)

*First New England Financial Corp. v Woffard*, 421 So.2d 590 (Fla Dist Ct App 1982)

*Flora Mir Candy Corp. v R.S. Dickson & Co (In re Flora Mir Candy Corp.)*, 432 F.2d 1060 (2d Cir. 1970)

*Geilfuss v Corrigan*, 95 Wis. 651; 70 NW 306 (1897)  
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*In re Coronet Capital Co*, 142 B.R. 78 (Bankr. S.D.N.Y. 1992)  
*In re DRW Property Co 82*, 54 B.R. 489 (Bankr.N.D. Tex. 1985)  
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*In re Murray Industries Inc.*, 119 B.R. 820 (Bankr. M.D. Fla. 1990)  
*In re Owens Corning*, 419 F 3d 195 (3<sup>rd</sup> Cir 2005)  
*In re Richton International Corporation*, 12 B.R. 555 (Bankr. N.Y. 1981)  
*In re Snider Bros, Inc.* 18 B.R. 230 (Bankr. D. Mass. 1982)  
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*Major's Furniture Mart, Inc v Castle Credit Corp*, 602 F. 2d 538 (3<sup>rd</sup> Cir 1979)  
*Mathews v New Century Mortgage Corp*, 185 F supp 2d 874 (SD Ohio 2002)

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*Shell Oil Co v Prestidge*, 249 F 2d 413 (9<sup>th</sup> Cir 1957)  
*Soviero v Franklin Nat'l Bank of Long Island*, 328 F. 2d 446 (2d Cir 1964)

*Unico v Owen*, 232 A.2d 405 (NJ 1967)  
*Union Savings Bank v Augie/Restivo Baking Co Ltd (In re Augie/Restivo)*, 860 F 2d  
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## 10.5 LIST OF LEGISLATION

### 10.5.1 South Africa

#### 10.5.1.1 Acts

Banks Act 94 of 1990  
Banks Amendment Act 20 of 2007

Close Corporations Act 69 of 1984  
Collective Investment Schemes Control Act 45 of 2002  
Companies Act 61 of 1973

Deeds Registries Act 47 of 1937

Financial Institutions (Investment of Funds) Act 39 of 1984  
Financial Institutions (Protection of Funds) Act 28 of 2001.



Insolvency Act 24 of 1936

National Credit Act 34 of 2005

Securities Services Act 36 of 2004

Security by Means of Movable Property Act 57 of 1993

Trust Property Control Act 57 of 1988

#### 10.5.1.2 Bills

Banks Amendment Bill, 12 of 2007

Companies Bill 61 of 2008

#### 10.5.1.3 Draft Bills

Draft Companies Bill, 2007

Draft Consumer Protection Bill, 2006

#### 10.5.1.4 Regulations and Notices

GN R153, GG 13723 (3 January 1992)

Notice on the Deposit-Taking Institutions Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘Business of a Deposit-Taking Institution’ (Securitisation Schemes)”

GN 2172, GG 16167 (14 December 1994)

Notice on Banks Act 94 of 1990 - “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Commercial Paper)”

GN 1375, GG 22948 (13 December 2001)

Notice on Banks Act 94 of 1990 – “Designation of an Activity no Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes)”

GN R185, GG 24351 (7 February 2003)

Debt Collectors Act 114 of 1998 - Regulations Relating to Debt Collectors, 2003

GN R663, GG 24867 (16 May 2003)

Debt Collectors Act 114 of 1998 – Code of Conduct

GN R681, GG 26415 (4 June 2004)

Notice on Banks Act 94 of 1990 - “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes)”

GN 2, GG 30628 (1 January 2008)

Notice on Banks Act 94 of 1990 – “Designation of an Activity not Falling within the Meaning of ‘The Business of a Bank’ (Securitisation Schemes)”

### 10.5.2 England

#### 10.5.2.1 Acts

Companies Act of 1985 c 6

Companies Act of 1989 c 40

Companies Act of 2006 c 46

Company Directors Disqualification Act 1986 c 46

Enterprise Act 2002 c 40

Financial Services Act of 1986 c 60

Financial Services and Markets Act of 2000 c 8

Insolvency Act of 1986 c 45

Law of Property Act of 1925 (15 & 16 Geo 5 c 20)

Supreme Court of Judicature Act of 1873 (36 & 37 Vict c 66)

Supreme Court of Judicature Act of 1875 (38 & 39 Vict c 77)

Supreme Court of Judicature (Consolidation) Act of 1925 (15 & 16 Geo c 49)

### 10.5.3 United States of America

#### 10.5.3.1 Acts

Equal Credit Opportunity Act (15 USC § 1691)

Fair Debt Collection Practices Act (15 USC § 1692)

Fair Housing Act (42 USC § 3601-3619)

Federal Trade Commission Act (15 USC § 41)

Home Ownership and Equity Protection Act (various sections of 15 USC)

Investment Company Act of 1940 (15 USC § 80a *et seq*)

Real Estate Settlement Procedures Act (12 USC § 2601-2616)

Securities Act of 1933 (15 USC § 77)

Securities Exchange Act of 1934 (15 USC § 78)

Truth in Lending Act (15 USC § 1601)

Uniform Commercial Code

Uniform Fraudulent Transfer Act of 1984

#### 10.5.3.2 State Acts

Asset-Backed Securities Facilitation Act of 2002 (73 Del. Laws c. 214 § 1 (2002), Title 6, Chapter 27A of the Delaware Code)

Ohio Revised Code Ann (Title 11, Financial Institutions) § 1109.75 (Securitizations)

Texas Business & Commerce Code Ann § 9.109(e)

#### 10.5.3.3 Regulations

Code of Federal Regulations

## 10.6 TABLE OF FIGURES

Figure 1: Simplified securitisation scheme.....	29
Figure 2: Security scheme using security SPV .....	63
Figure 3: Agency construction of a debenture trust.....	72
Figure 4: <i>Bewind</i> trust construction of trust for debenture-holders .....	80
Figure 5: True trust construction of trust for debenture-holders.....	82
Figure 6: Trust for debenture-stockholders.....	84
Figure 7: Simplified collective investment scheme .....	306



## INDEX

- A**
- Administrator ..... 117
- Agency  
 compared with trust ..... 66  
 distinguished from mandate ..... 350
- Article 9 UCC ..... 154–67
- 'account' ..... 156, 162
- 'chattel paper' ..... 157
- 'payment intangible' ..... 157, 162
- 'proceeds' ..... 157
- sale of accounts ..... 155, 165–67
- assignment ..... 165
- security interest ..... 155, 158–65
- attachment ..... 160
- control ..... 163
- notice filing ..... 160–62
- perfection ..... 160, 162
- priority ..... 164
- Asset-backed securities ..... 172
- commercial ..... 40
- consumer ..... 40
- Auditor ..... 265, 268, 298, 300, 424
- B**
- Basel committee ..... 260, 263, 278
- C**
- 'Business of a bank' ..... 260, 263, 265, 269, 273, 275, 418
- C**
- Cession ..... 323, 327, 328–35, 386, 440, 441
- defences ..... 334
- definition ..... 328
- delivery of document ..... 328–31, 347
- doctrine of all effort ..... 328
- dual nature ..... 332
- future claims ..... 344–49, 431
- notice to debtor ..... 332–33
- set-off ..... 333
- valid *causa* ..... 331–32
- Charge ..... 210, 211
- book debts ..... 99–107
- proceeds ..... 100, 106
- definition ..... 95
- fixed ..... 95, 133
- book debts ..... 96, 99
- floating ..... 96
- advantages ..... 120
- business continuance ..... 108
- business-dealing licence ..... 98, 109, 111
- characteristic elements ..... 97–99
- crystallisation ..... 112, 114–18
- disadvantages ..... 121–25
- implied terms ..... 107–14
- negative pledge clause ..... 123
- ostensible authority to deal ..... 122
- priority ..... 121
- registration ..... 124
- Clean-up call ..... 274
- Collateralised debt obligations ..... 41
- Collective investment schemes 31, 308–13, 425–26, 441
- definition ..... 311
- England ..... 126–28
- United States of America ..... 168–72
- Collective security arrangement ..... *See* Trust for debenture-holders
- Commercial paper ..... *See* Debentures: commercial paper
- Companies
- affected transactions ..... 294–96, 306–7, 425
- definition ..... 294
- capacity ..... 301, 424
- conflicts of interest ..... 296–97, 424
- constitutive documents ..... 300, 424
- disposal of undertaking ..... 292–94, 306, 423
- doctrine of constructive knowledge ..... 303
- memorandum of incorporation ..... 300–302, 424
- registers ..... 217, 297, 329, 331
- secretary ..... 297, 424
- separate legal personality ..... 30
- separation of powers ..... 291, 305
- Turquand* rule ..... 293
- ultra vires* doctrine ..... 302–5
- Conduit ..... *See* SPV
- Consolidated accounts ..... 128
- Consumer protection ..... 173–78, 280–91, 422–23
- credit provider ..... 289–91
- debt counsellor ..... 285, 286
- debt rearrangement ..... 285, 286
- definition of 'consumer' ..... 281
- financial assessment ..... 283, 284
- over-indebtedness ..... 282–83
- definition ..... 282
- reckless credit ..... 283–85
- compared with over-indebtedness ..... 285
- suspension of credit agreement ..... 284, 285
- unlawful credit agreements ..... 287–88
- Credit enhancement ..... 43–45, 46, 59, 269, 274
- definition ..... 20
- interest swap ..... 44
- overcollateralisation ..... 43
- reserve account ..... 44
- two-tier issue ..... 44
- Credit rating ..... 20, 45, 282, 305, 362, 381, 422
- investment grade ..... 45, 170, 182
- unsolicited ..... 49
- D**
- Debenture stock ..... 215–16
- Debentures ..... 209–18, 412
- bearer ..... 214
- characteristics ..... 215
- commercial paper ..... 263–65, 267–68, 272, 273, 274
- debt instrument ..... 218
- definition ..... 210–15
- document ..... 210, 211, 212, 213, 214, 218
- security ..... 217

- Debt collectors ..... 313–15, 350, 426  
 Debt financing ..... 204, 207, 208, 209, 216  
 Delegation..... 323–27, 337, 420, 421, 427, 428, 430, 441  
   compared to assignment ..... 323  
   compared to cession..... 324  
   consent of debtor ..... 324  
   definition ..... 323  
 Disclosure requirements..... 264, 268, 272, 298–99  
 Disguised transaction ..... *See* True sale: simulated transactions  
 Disintermediation..... 261  
 Doctrine of constructive notice ..... 236  
 Doctrine of enterprise liability ..... 199–200  
 Doctrine of notice ..... 249
- E**
- Equitable assignment ..... 129–33  
   definition ..... 129  
   notice to debtors ..... 130, 131  
 Equitable security  
   compared to legal security ..... 94  
 Equity financing..... 204, 216
- F**
- Factoring..... 87, 313, 364, 370  
 Fannie Mae .....*See* Federal National Mortgage Association  
 Federal Home Loan Mortgage Corporation ..... 153  
 Federal National Mortgage Association..... 153  
 Fiduciary security cession..... 246–48, 252–53, 290, 353, 362, 372, 417, 423  
   not accessory ..... 247  
   notice to debtors ..... 252  
   *pactum fiduciae* ..... 246  
   proceeds..... 248, 252  
   transfer..... 341  
 Freddie Mac .....*See* Federal Home Loan Mortgage Corporation
- G**
- Gearing ..... 205–8  
 Ginnie Mae .....*See* Government National Mortgage Association  
 Government National Mortgage Association..... 153  
 Government-sponsored entities..... 153–54
- H**
- History ..... 12, 14, 151, 153
- I**
- Impeachable transactions ..... 244, 384–400, 434–36  
   *actio Pauliana* ..... 405–6, 436  
   collusive dispositions..... 396–98, 436  
   'creditor' ..... 145, 390, 391  
   disposition ..... 230, 231  
   meaning of..... 386–87, 434  
   meaning of 'value'..... 387–89  
   undervalue ..... 141  
   dispositions without value ..... 385–89, 435  
   rights of third parties..... 399–400, 436
- transfer of business by trader . 400–404, 437, 442  
   meaning of 'trader' ..... 402, 403  
 undue preferences ..... 230, 395, 435, 436  
 voidable preferences ..... 230, 394, 435, 436  
   intention to prefer ..... 393–94  
   ordinary course of business ..... 391–93  
 Insider debt ..... 208–9  
   definition ..... 208
- J**
- Judgment proofing ..... 29
- L**
- Lease  
   finance lease ..... 327  
   operating lease ..... 327  
 Leveraging ..... *See* Gearing  
 Liquidity support..... 44, 59  
 Loan ..... 363, 366, 368
- M**
- Mandate ..... 350, 352, 432  
 Mortgage Electronic Registration System..... 177  
 Mortgage-backed securities  
   commercial ..... 40  
   residential ..... 40  
 Multi-seller vehicle ..... *See* SPV: conduit
- N**
- Non-assignment clauses *See Pactum de non cedendo*  
 Non-petition clauses..... *See Pactum de non petendo*  
 Novation ..... 323, 324, 337, 428
- O**
- Obligatory agreement..... 18, 320, 321–22, 362  
   abstract system of transfer of rights 18, 331, 332, 427  
 Offers to the public ..... 260, 273, 298, 418  
 Originator..... 262, 266, 269, 271, 273, 274, 326, 340  
   as servicer ..... 270, 361  
   definition ..... 20  
   solvency..... 441  
   ultimate borrower ..... 264
- P**
- Pactum de non cedendo* ..... 137–39, 167, 270, 341  
*Pactum de non petendo* ..... 38, 58, 412  
*Parate executie* clause..... 229  
*Pfandbriefmarkt* ..... 16  
 Pledge of claims..... 243–46, 251–52, 290, 417, 423  
   accessory nature..... 243  
   entitlement to realise claims ..... 245, 251  
   notice to debtors..... 244, 251  
   proceeds..... 245, 252  
   publicity ..... 243  
   transfer..... 341  
*Procuratio in rem suam* ..... 352, 353, 358

## R

- Rating agencies 45–52, 182, 194, 259, 301, 411, 438  
 disclaimer ..... 50  
 fees ..... 48  
 liability towards third parties ..... 49  
 regulation ..... 47  
 Receiver ..... 115, 118–20, 120, 240  
 possession ..... 119  
 Responsible lending ..... *See* Consumer protection  
 Rule in *Dearle v Hall* ..... 122, 131

## S

- Security ..... 220–53, 415–17, 439  
 by means of claims ..... 241–48  
 fiduciary security cession ..... *See* Fiduciary security cession  
 pledge of claims ..... *See* Pledge of claims  
 future debts ..... 73  
 general notarial bond 223–41, 249–51, 290, 415, 423  
 alienation ..... 224  
 automatic perfection ..... 227  
 doctrine of notice ..... 249  
 hypothecation of a shop ..... 225, 226  
 negative pledge clause ..... 227  
 perfection ..... 228–39, 439–40  
 preference ..... 239  
 priority ..... 223, 234, 236, 237, 240, 249  
 registration ..... 250  
 instalment sale ..... 342  
 personal  
 compared to real ..... 220  
 guarantee ..... 220  
 suretyship ..... 220  
 purpose ..... 218–19  
 real  
 accessory nature 73, 75, 77, 79, 324, 335, 336, 337, 414, 428  
 covering bond ..... 335, 338  
 mortgage ..... 221  
 pledge ..... 221  
 real agreement ..... 336, 337  
 special notarial bond ..... 221, 222, 241  
 transfer ..... 335–44, 428–29, 441  
 covering bond ..... 338–40, 429–30  
 instalment sale agreements ... 342–44, 430–31  
 mortgage ..... 336–38  
 notarial bond ..... 336–38  
 security by means of claims ..... 341–42  
 surety ..... 341  
 Security SPV ..... 56, 58–62, 290, 412, 438  
 guarantor ..... 58, 60, 62, 413  
 Servicer ..... 20, 52–54, 132, 325, 333, 342, 420  
 back-up ..... 53  
 relationship with SPV ..... 349–62, 432–33, 441  
 cessionary for collecting purposes ..... 359–62, 432  
 mandatary *in rem suam* ..... 352–58, 432  
 representative ..... 352, 432  
 separate accounts ..... 53

- Special purpose vehicle ..... *See* SPV  
 SPV ..... 31–39, 262, 289, 400  
 capacity ..... 37, 266, 273, 298, 304, 424  
 capitalisation ..... 33, 35  
 conduit ..... 34, 38  
 corporate governance ..... 35, 267, 272, 326, 421  
 definition ..... 20  
 insolvency insulation ..... 37, 39, 305, 362, 428  
 insolvency-remoteness ..... 139–47, 194–99, 325, 382, 383, 398, 419  
 requirements ..... 139  
 master trust ..... 32  
 pass through ..... 31  
 pay through ..... 32  
 relationship with servicer ... 349–62, 432–33, 441  
 Subprime market ..... 173, 174  
 Substantive consolidation ..... 188–94  
 Summary execution clause ..... *See* *Parate executie* clause  
 Synthetic securitisation ..... 11, 269

## T

- Traditional securitisation ..... 11, 24, 278  
 advantages ..... 24–31  
 Transfer agreement .18, 289, 321, 322–35, 345, 362, 427–28  
 True sale ..... 12, 61, 155, 179, 185–88, 325, 382  
 characteristics ..... 129  
 control by originator 32, 273, 274, 349, 370, 419, 440  
 recharacterisation ..... 18, 41, 136, 186, 188, 363, 364, 371, 434  
 recourse ... 27, 187, 262, 266, 269, 274, 362, 369, 370, 434  
 simulated transactions.. 18, 361, 362–73, 433–34  
 Trust for debenture-holders. 56, 250, 290, 362, 413–15, 438  
 benefits ..... 54  
 legal form ..... 62–80  
 agency ..... 63, 64, 68, 414  
*bewind* trust ..... 75, 415  
 true trust ..... 78, 415  
 trust ..... 70, 414  
 transfer of ownership ..... 67, 75, 76  
 trust deed ..... 72, 84  
 Trust for debenture-stockholders ..... 80  
 no transfer of ownership ..... 82  
 Trustee for debenture-holders 62, 86, 259, 413, 422, 440  
 access to information ..... 84  
 discretion ..... 84, 85  
 duties ..... 83, 85  
 remuneration ..... 86

## U

- Undisclosed principal ..... 354, 355, 358, 432

## W

- Whole business securitisations ..... 41