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Preface

For several reasons I am especially pleased with this one.

First there is the diversity of the contributors: we have, as ever, the academics – many of whom have proud records of much sterling work in banking law. Those of you who have been attending ABLU conscientiously over the past years will recognise them, and, I hope, will agree with me that, in military metaphor, they have earned their stripes. However, I am especially pleased that the participants in today's ABLU include no less than 4 full-time practitioners: three attorneys and one advocate. Their contributions are important. It is a sad fact that many of the legal problems today escape the attention of academics for the simple reason that they never find their way into the law reports. So many disputes are settled (with or without the input of an ombud) and so many go to confidential arbitration. Hence, it is my sincere hope that contributions from legal practitioners to ABLU will increase in future. The diversity of contributors is further complemented by bankers (and very different bankers as well: one with a lifetime of experience with one of the large commercial banks in South Africa, the other with the European Investment Bank – an entirely different type of institution). Finally, I am delighted that we also have contributions from two doctoral students. Theirs is a lonely task, and we are pleased that they can share some of their work with us today.

Secondly, there is the diversity of the subject-matter, all of which is highly topical. Legal tender and tax, financing of projects (be it by money administered by the European Union or acquired by means of loan syndication), the continuing struggle to deal with the Companies Act and the NCA and the attempts of our courts to give clear guidance on our law relating to demand guarantees, all feature in this bundle today. On the public-law aspects of banking, the importance of reflecting carefully on financial regulation as we approach a new regulatory regime in South Africa is self-evident.

Three of our speakers have travelled from abroad. Professor Geva (from Toronto in Canada) and Professor Möllers (from Augsburg in Germany) have both spoken before at ABLU. We are privileged to host such eminent scholars here again. We are pleased to welcome, too, Mr Buchhöcker (from Bayreuth in Germany). We further have delegates from Kenia, Namibia and Lesotho present today. To all of you we wish a happy time in South Africa.

A special word of thanks is due to our chairpersons of the different sessions: Professors Jopie Pretorius, Andreas van Wyk, Willem Krüger and Jannie Otto, and Mr Anton du Randt. Their combined experience and knowledge is immeasurable. Also, to all who have written papers and prepared presentations, my sincere and humble gratitude. The amount of work you have done emerges clearly from this bundle.

I would also like to thank three persons who have worked hard behind the scenes to make today possible: Ms Marietjie van Wyk, Ms Antoinette Jacobs and Ms Lara Engelbrecht. A very special word of thanks is also due to Norton Rose Fulbright for making this magnificent venue available to us.

Finally, to all our attendees: thank you for your support. It is my goal that ABLU should be of significant value to you. May the research reflected here save you time, assist you in making correct decisions and withhold you from making disastrous ones. May the conference also, as it has done for me over many years, prove to be fertile ground for the forging of (professional) friendships.

Professor Charl Hugo

Director: Centre for Banking Law
University of Johannesburg
28 May 2015

<u>Legal tender in South African law</u>*

*SF du Toit***

1 *Introduction*

The end of the cash era in South Africa is perhaps not quite as close as is often proclaimed: "... to paraphrase Mark Twain, reports of the demise of cash are greatly exaggerated" (Williams "2012 Annual report essay: Cash is dead! Long live cash!" www.frbsf.org/our-district/about/annual-report/annual-report-2012/2012-annual-report-essay-cash-is-dead-long-live-cash (28-07-2014)). The *New York Times* published a brief article in 2014 under the heading: "Checks are expendable, but in legal tender we trust" (Corkery 4-02-2014 F12), where it indicated that more American bank notes flow through the financial system than at any other time in recent history. The cheque therefore seems to be expendable, though not quite dead yet (*cf* Leibbrandt *Why Americans Still Write Cheques: Network Technologies in a World with Borders* (2004)) – while our enduring faith in cash should not be underestimated. One of the large South African banks indicated more than a year ago that monthly card payments and different forms of electronic funds transfers, surpassed cash withdrawals at ATMs with R800 million ("Card payments overtake cash: FNB" http://businesstech.co.za/news/banking/48841/card-payments-overtake-cash-fnb (4-11-2013)). Statistics from the South African Reserve Bank's *Quarterly Bulletin* indicate to what extent there is a move away from especially the use of cheque payments (McKendrick *Goode on Commercial Law* (2010) 519 refers to the "decline in the importance of instruments" because of electronic funds transfer systems) and how payment by way of electronic funds transfer becomes more prevalent (par 5 below). However, as the last of the negotiable instruments lecturers might still tell students, the method of payment providing the most protection when one wants to pay a large amount to someone, is drawing a non-transferable cheque. (*Cf* also Malan and Pretorius "The perfect cheque?" 1977 *TSAR* 77, written long before s 75A formed part of the Bills of Exchange Act 34 of 1964.) In the case of cheque payments, a system balancing the interests of different parties already exists, without the absolute exclusion of liability (or at least attempt at the absolute exclusion of liability) that banks sometimes contractually impose on their clients in the case of credit transfers or card payments. (The Consumer Protection Act 68 of 2008 and the Code of Banking Practice (2012) (see Du Toit "Reflections on the South African Code of Banking Practice" 2014 *TSAR*) may well play an important remedial role here.) The disadvantages of cash are well- known, and include aspects such as costs related to the manufacturing and

* An expanded version of this paper was published in 2014 *TSAR* 805.

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handling thereof, possible forgeries and theft (see Geva *The Payment Order of Antiquity and the Middle Ages: A Legal History* (2011) 38-39; for some advantages, including the following, see Williams: "you can count on cash even when other payment methods might not be working, during power outages and natural disasters, for example"). We may be some years away in South Africa from a cashless society, but new forms of money and methods of payment, create challenges for the legal framework within which payments must take place.

This framework should take into consideration the notion of *financial inclusion*. The discourse regarding new forms of payment and money takes place to a large extent within the context of financial inclusion, and also within the context of money laundering and the financing of terrorism. (See the series of articles following Winn and De Koker "Introducing mobile money in developing countries: financial inclusion and financial integrity conference special issue" 2013 *Washington Journal of Law, Technology & Arts* 155.) Financial inclusion may defined in the following manner:

> "Full financial inclusion is a state in which all people of working age have access to a full suite of quality financial services that includes payment services, savings, credit, and insurance. These services are provided at affordable prices, in a convenient manner, and with dignity for the clients" (Winn "Governance of global mobile money networks: the role of technical standards" 2013 *Wash JL Tech & Arts* 197 200 quoting from Center for Financial Inclusion at ACCION International "Mexico's prospects for full financial inclusion" A white paper from the financial inclusion 2020 project, draft for discussion, Sep 2009 p 4 centerforfinancialinclusionblog.files.wordpress.com/2011/10/mexicos-prospects-for-full-financial-inclusion-english.pdf (1-11-2013); *cf* also Code of Banking Practice s 5).

It is submitted that one cannot abolish cash without an alternative that is affordable and convenient, and which does not affect the dignity of clients in any way. Despite the fact that cash will still be available in South Africa in the foreseeable future, Proctor is correct when he refers more than once to the diminishing importance of the concept "legal tender":

> "This leads to a natural and inescapable conclusion; in a world in which the use of cash as a means of payment is steadily decreasing, the importance of the formal concept of legal tender necessarily diminishes at the same rate" (*Mann on the Legal Aspect of Money* (2012) 76, also 74 fn 49; see also Fox *Property Rights in Money* (2008) 29).

<u>*2 Money*</u>

Money is not defined by South African legislation (Malan, Pretorius and Du Toit *Malan on Bills of Exchange, Cheques and Promissory Notes in South African Law* (2009) 43). The South African Reserve Bank Act (90 of 1989) provides that the Reserve Bank has the sole right to issue banknotes and coins, and that the monetary unit of the Republic is the rand and the cent (s 14(1) and s 15(1)). The principle of nominalism governs the payment of a monetary debt: "the debtor is obliged to pay the nominal sum of the monetary units of account, regardless of fluctuations in the purchasing power of the currency since the creation of the obligation" (Van der Merwe *et al Contract: General Principles* (2012) 442 and authority in fn 19; Proctor 255 *et seq*).

There are also not very many apposite references to money in South African legislation, with the exception of recent, somewhat problematical, references in the Consumer Protection Act (s 62(1)(a), s 63(3), s 64(1) and s 65(2)-(3); *cf* Otto "Bêrekope en die *Consumer Protection Act*" 2013 *TSAR* 139 149-150; see further Proctor 6-8). An example is the definition of a bill of exchange in the Bills of Exchange Act (s 2(1)), where the Act refers to payment of a "sum certain in money" (Malan, Pretorius and Du Toit 42-43; an act may not be required in addition to the payment of money: Bills of Exchange Act s 2(2)). The Banks Act (94 of 1990 s 1 *sv* "deposit" (a)) defines a "deposit" as "an amount of money paid by one person to another person subject to an agreement in terms of which ... an equal amount or any part thereof will be ... repaid ..." (the Co-Operative Banks Act (40 of 2007 s 1 *sv* "deposit") refers back to the definition in the Banks Act).

Regarding the juridical nature of money, an interesting development took place from Frederick Mann to Charles Proctor. (See Proctor chap 1 as well as the 5th and older editions of the work by Mann. See also the way in which Perlman *Legal and Regulatory Aspects of Mobile Financial Services* (2012 thesis Unisa) chap 3 reconciles economic and legal theory.) Mann decided in 1936 to write a book on the law of money in English (see Proctor vii (preface to the 6th ed written by David Mann)). The first edition of Mann's book, *The Legal Aspect of Money*, was published in 1938. For purposes of this paper, the description of money in the 2012 edition, should suffice – the reference to "chattels" has fallen away previously already, and money includes, for example, bank deposits or bank money (Geva 525; Geva 25 and 493 also refers to "commercial-bank money to distinguish it from money held by a central bank). Proctor states that the essential legal characteristics of money are:

> "(a) it must be expressed by reference to a name and denominated by reference to a unit of account which, in each case, is prescribed by the law of the State concerned;
> (b) the currency unit so prescribed must be intended to serve as the generally accepted measure of value and medium of exchange within the State concerned;
> (c) the legal framework for the currency must include a central bank or monetary authority responsible for the issue of the currency, and including the appropriate institutional provisions for its management through the conduct of monetary policy and the oversight of payment systems" (41).

It should further be kept in mind that the concept of money is probably of less importance than the concept of payment, as indicated by Goode (McKendrick 488). (With recent constructs such as electronic money and mobile money, it may nevertheless be necessary to reconsider money as a legal concept, as was done by Perlman – see *inter alia* chap 13; further discussion of the concept of money falls outside the scope of this paper. See Du Toit "Die dematerialisasie van geld: in die skadu van die sakereg" 2009 *TSAR* 1 regarding the distinction between money and a method of payment (3) and regarding the concept of payment (4-5 and 16-17).)

3 *Legal tender*

In principle a debtor must offer payment "met openbeurs en klinkende munt" (*B & R Investments (Pty) Ltd v Laubscher* 1951 2 SA 567 (T) 570). Regarding the juridical nature of money, there seems to be little legislative guidance, but within the wider definition of money, section 17 of the South African Reserve Bank Act defines what is regarded as legal tender in South African law – a much narrower concept. All forms of legal tender will be money, but money is not necessarily legal tender:

> "The authorities ... clearly recognize the distinction between money which is, and money which is not, legal tender. In other words all legal tender is money, but not all money is legal tender" (*Vick v Howard* 116 SE 465 468; *The Emperor of Austria v Day and Kossuth* (1861) 3 De G F & J 217 234).

The concept of legal tender includes notes of the Reserve Bank (for payment of any amount), gold coins (for payment of any amount) and other coins, which will only comprise legal tender up to certain limits. (The problems surrounding the use of gold coins as legal tender, fall outside the scope of this paper: see the discussion by Pretorius "The bona fide purchaser of a Krugerrand" 2004 *SA Merc LJ* 466 and Proctor 36-40.) Coins with a denomination of 5c, for example, will only be legal tender for an amount up to 50c (s 17(2)(b)(iii)). The definition is of course rather archaic, but similar definitions are often found in other jurisdictions. In the UK, comparable provisions can be found in the Coinage Act 1971 (s 2) and the Currency and Bank Notes Act 1954 (s 1). In the USA it is determined that "United States coins and currency ... are legal tender for all debts, public charges, taxes, and dues" (31 USC § 5103). A useful simplification is found in the Eurozone: a limit of 50 is placed on the number of coins that may be presented for a single payment (*Council Regulation (EC)* no 974/98, 4 May 1998 s 11).

Legal tender in South Africa is therefore limited to coins and notes – a creditor can in principle (but see par 5 below) insist on payment by way of legal tender, and a debtor can insist to pay in legal tender (see Geva 25-26) – *ie* in cash. In the South African media cases were reported of merchants who refused to accept R200 notes ("Is this notice even legal?" *Sunday Times* (2-06-2013) 15). A merchant might also refuse to accept any cash at all. In paragraph 5 such instances are considered in more detail.

4 *Tender*

The notion of a tender of payment, can be linked to a tender of performance. According to Christie and Bradfield (*Christie's The Law of Contract in South Africa* (2011) 420):

> "To be a valid tender it must comply with all the requirements of a valid performance, since the basis of the effect which the law gives to a valid tender of performance is that the debtor was correct in thinking that what he was attempting to achieve amounted to proper performance and that it was due to no fault of his own that he was unable to achieve it" (the meaning of "tender" relevant here, is the last of four possibilities referred to by Christie and Bradfield – discussed on p 419 *et seq*).

There are a number of older English cases that are of interest when considering a tender of money (compare *eg Dixon v Clark* 1848 5 CB 365 (136 ER 919) 377 with the quotation from Christie and Bradfield above; see further Geva 26-32 – in what follows only a few cases discussed by Geva are referred to for purposes of illustration; most of these cases should be applied with some caution today). According to *Brady v Jones* (1823 2 Dow & Ryl 305, quoted in *Wade's Case* 1601 5 Co Rep 114a (77 ER 232) 115a fn (C)), there must be proof of the tender of the specific amount due, and such tender may not be qualified in any way. A tender of a larger amount, thus requiring change, is not a proper tender of the smaller amount (*Robinson v Cook* 1815 6 Taunt 336 (128 ER 1064); Proctor 75 fn 52; but *cf Wade's Case* 115a point 3) – unless the creditor agrees to providing change. The money must be produced (*Dickinson v Shee* 1801 4 Esp 67 (170 ER 644) 68; see also *Thomas v Evans* 1808 10 East 101 (103 ER 714) 103; *Finch v Brook* 1834 1 Bing (NC) 253 (131 ER 1114) 256-258 and *Ex parte Danks. In the Matter of Farley* 1852 2 De G M & G 936 (42 ER 1138) where it was found that, even though the money was not produced, at least the coins were shaken so as to produce a sound (941)). If the debtor placed his hand in his pocket to remove the money, but the creditor left the room before the money was produced, no proper tender was made (*Leatherdale v Sweepstone* 1828 3 Car & P 342 (172 ER 448) 343). According to Lord Tenterden CJ: "This is no tender, the plaintiff got away before any tender could be made." It is rather doubtful whether the fact that the creditor managed to get away – after the defendant stated out loud that he offers to pay the creditor – should be held against the debtor. In *Alexander v Brown* (1824 1 Car & P 288 (171 ER 1199) 289) it was found that there is a proper tender where the person stated what the amount being offered is, holding the money in his hand (though not opening his hand): in the case two banknotes were twisted together, together with some coins as well. Money held in bags does not, as such, amount to a proper tender (*Sucklinge v Coney* 1598 Noy 74 (74 ER 1041)). The basis of the decision is not quite clear (the law report in the *English Reports*, to which I had access, is composed of six lines; also see Geva 28), but apparently the creditor must be provided with the opportunity to examine the money. According to *Wade's Case*, there will be a proper tender, even where the money is not shown, or counted, as long as the correct amount was present (115a), but it is suggested that the relevant part of the decision (115a point 4) still requires that at least an opportunity must be provided to count the money: "then it is the part of the mortgagee to count it if he will". In principle the money must be counted at a convenient time before sunset (*Wade's Case* 114b; *Tinckler v Prentice* 1812 4 Taunt 549 (128 ER 445) 554; Christie and Bradfield 421 and 448; but *cf* today *Afovos Shipping Co SA v Romano Pagnan and Pietro Pagnan (trading as R Pagnan & F lli)* 1982 1 WLR 848 853F).

As stated earlier, one should be circumspect in applying these cases to modern circumstances, although useful analogies may sometimes be drawn.

Du Toit

5 *Accepting an alternative method of payment by virtue of contract*

Proctor remarks: "As far as is known, litigation concerning legal tender legislation as a means of discharging monetary obligations is virtually non-existent …" (31 n 132). Interesting links may, however, be found in cheque law. Christie and Bradfield (431) wrote:

> "In modern commercial practice payment by cheque is so common that for many types of transaction it can be properly regarded as the normal method and payment in cash the exception. ... Payment means payment and money means money, so a contractual obligation to pay money must ... be performed *in forma specifica* unless, on a proper interpretation of the contract, performance *per aequipollens* will suffice to discharge the debtor."

First, one should keep in mind that, as indicated above (par 3), money and cash are not synonyms. Secondly, the quotation dates from older editions of the book (see *inter* alia the 2006 ed 415) and the statement was probably correct at a time when cheques were still used widely. In South Africa, that is not the case anymore. In 2013 (South African Reserve Bank (SARB) *Quarterly Bulletin* Jun 2014 S-13) the value of cheque payments (R310 818 million) is still more than that of credit card transactions (R214 756 million), but both are eclipsed by the value of electronic transactions, amounting to R7 571 467 million. The number of transactions should also be considered: the number of cheque payments (18.771 million) and the number of credit card transactions (403.762 million) are both surpassed by the number of electronic transactions (839.194 million).

It is suggested that one can derive from these statistics that the credit transfer, rather than payment by cheque, should in some instances be considered as the "normal method" of payment in South Africa today. Cheque cases may, however, still be quite useful when looking for indications that a credit transfer should be accepted as a method of payment. In *Schneider and London v Chapman* (1917 TPD 497) the court held:

> "... having regard to the course of commercial dealings in the modern world, which is so very different from what it used to be two or three hundred years ago, the Court will not require very strong evidence to show that the parties in the particular transaction contemplated that payment might be made by cheque" (500 *per* De Villiers JP); and
> "Now, I admit that if this case had to be decided in the days of Justinian, or even in the days of Voet, the court would have found that it [payment by cheque] was not good payment, because it was not the custom in those days to pay money by cheque. But although lawyers are notoriously conservative, there is a time at which the law has to conform itself to the commercial usages of the day. It is a well-known fact that ... [in the USA] ninety percent, of the payments that are made daily are made by cheque, not in coin, and it is absolutely necessary for this Court to take notice of this fact" (503 *per* Wessels J).

The only requirement is "some slight indication in the contract" from which it can be derived that payment must be made by way of a cheque (*Esterhuyse v Selection Cartage (Pty) Ltd* 1965 1 SA 360 (W) 361). Similarly, "commercial dealings in the modern world" and trade custom today indicate that at least certain payments are effected by way of credit transfer, and it is submitted that a court should take cognisance of the Reserve Bank's statistics regarding electronic transactions. In *Vena v Vena* (2010 2 SA 248 (ECP) par 12) reference is made to parties who do not have huge amounts of money within reach, but it is suggested that the amount does not need to be so high for an inference against the use of cash. (*Cf* also art 6.1.7(1) of the *Unidroit Principles of International Commercial Contracts* (2010), under the heading "Payment by cheque or other instrument", "[p]ayment may be made in *any form used in the ordinary course of business* at the place for payment" (my emphasis).)

Important considerations as to whether performance *in forma specifica* is expected, and whether performance *per aequipollens* will be sufficient, are set out in *Van Diggelen v De Bruin* (1954 1 SA 188 (SWA) 192-193). It is more likely that a court will decide in favour of performance *per aequipollens* if "the manner of performing ... is not material" and such performance "[is] an equivalent act to that mentioned in the contract or [is] of such a nature that it can make no material difference to the promisee." While there may be circumstances requiring the handing over of cash, the method of payment will often not be of fundamental importance. As remarked by Claassen J: "The Court's paramount concern is always, within the framework of the law, to do justice between man and man." To force one of the parties to pay in cash or to accept cash, might often not amount to justice between the parties. (Also see the *Schneider* decision 501 where the court refers to the insistence on legal tender as "a dangerous rule ... which could easily be turned into an engine of oppression ..." (with some further qualifications). See further regarding the possible acceptance of cheques as method of payment in South Africa, *Buys v Roodt (nou Otto)* 2000 1 SA 535 (O) 540-541; *Meikle and Co Ltd v Van Eyssen* 1950 2 SA 405 (T) 412-413; *Tjollo Ateljees (Edms) Bpk v Small* 1949 1 SA 856 (A) 876; *Rennie NO v The Master* 1980 2 SA 600 (K) 615; *Sibbald v Dakota Motors* 1956 3 SA 203 (T) 206-207; *B&H Engineering v First National Bank of SA Ltd* 1995 2 SA 279 (A) 285.)

There are of course also decisions requiring payment by way of legal tender, but often such decisions can be explained by the surrounding circumstances. (See *eg Blumberg v Life Interests and Reversionary Securities Corp* 1897 1 Ch 171 173: "A solicitor who has authority to accept a tender accepts anything short of a tender in cash at his own risk." The reason is that "acceptance of a cheque involves passing a judgment on the solvency of the person who tenders the cheque.") Proctor nevertheless remarks that "the courts will be very astute to find that the obligation to pay in cash has been varied or waived" (183) and "the courts cannot now be expected to lend their assistance to a vexatious creditor who refuses to accept a reasonable means of payment" (184 fn 30, 185).

The parties can therefore agree contractually on the payment method to be used:

> "In contract, where the debtor is obliged to pay money to the creditor, the medium of payment must be that which the contract expressly or impliedly specifies, as determined by reference to its terms and such evidence of custom, usage and the surrounding circumstances as is admissible to aid in its interpretation" (*Esterhuyse* 361; also see *Vena* par 11-12).

According to Proctor, the rule regarding legal tender is "in all respects subordinate to the terms of the contract" (183). It is submitted that the method of payment should be dealt with as follows. If the parties agree at the time of the conclusion of the contract on a method of payment, such choice will be valid. As long as it is clear at the time of concluding the contract how payment must take place, no party will be prejudiced.

It is also possible that the method of payment may be derived from a tacit term, or even a *naturale* derived from custom. (See Du Toit "Reflections on the South African Code of Banking Practice" 2014 *TSAR* for further discussion.) If a large amount (*eg* the purchase price of a house) must be paid, and no mention is made of a method of payment, one can probably assume that it is likely that there is a tacit term that payment can be made by credit transfer (or even a cheque). In the case of a large amount, as in this example, a term regarding a method of payment other than legal tender is "necessary in the business sense to give efficacy to the contract", and if the parties were asked at the time of concluding the contract how payment should take place, they would (probably) have replied that it must be by credit transfer (see *Reigate v Union Manufacturing Co (Ramsbottom) Ltd* 1918 1 KB 592 605). According to Proctor, "Where large amounts are involved, payment by legal tender is frequently unthinkable and *cannot possibly be within the contemplation of the parties*" (184 – my emphasis).

If a tacit term cannot be proved, it is suggested that one should attempt to prove a custom in terms of which payment should take place by credit transfer, forming part of the *naturalia* of the contract. (*Cf Martin v Rhode Island Co* 32 RI 162, 78 A 548 and *Nemser v New York City Transit Authority* 140 Misc 2d 369, 530 NYS 2d 493.)

The more difficult situation is where a contract is concluded, not mentioning any method of payment, and where, for argument's sake, no tacit term or custom regarding the method of payment, could be proved. According to Proctor,

> "it must nevertheless be emphasized that the validity of any payment or tender otherwise than by legal tender does depend upon the express or implied consent of the creditor; whilst this may easily be inferred, it is not possible to dispense with it" (185, 186).

Some assistance may be found in other jurisdictions – but in the form of pronouncements by the authorities, rather than the positive law. The Treasury in the USA explains:

> "There is, however, no Federal statute mandating that a private business, a person or an organization must accept currency or coins as for payment for goods and/or services. Private businesses are free to develop their own policies on whether or not to accept cash unless there is a State law which says otherwise. For example, a bus line may prohibit payment of fares in pennies or dollar bills. In addition, movie theaters, convenience stores and gas stations may refuse to accept large denomination currency ... as a matter of policy" (www.treasury.gov/resource-center/faqs/Currency/Pages/legal-tender.aspx (28-07-2014); see www.rmcp-grc.gc.ca/count-contre/faq-eng.htm (28-07-2014) for a similar point of view in Canada with reference to s 8 of the Currency Act RSC 1985 c C-52).

It is unlikely that cash can be declined in South Africa merely "as a matter of policy" without a contractual basis. In the UK one finds comments that do not seem to be so far-reaching:

> "Legal tender has a very narrow and technical meaning in the settlement of debts. ... It does not mean that any ordinary transaction has to take place in legal tender or only within the amount denominated by the legislation. Both parties are free to agree to accept any form of payment whether legal tender or otherwise according to their wishes" (www.royalmint.com/aboutus/policies-and-guidelines/legal-tender-guidelines (28-07-2014)).

However, if there are no express or tacit terms, and no custom regarding the method of payment, the parties will have to fall back on what is regarded as legal tender.

It is submitted that it should often be possible for a court to recognise a relevant tacit term or custom regarding the method of payment, by looking at the conduct of the parties, previous transactions and the surrounding circumstances. (See *Van Diggelen* 193. *Cf* also Cornelius "The legal nature of payment by credit card" 2003 *SA Merc LJ* 153 166 where he argues that the Visa or MasterCard signs in the windows of a supplier are indicative of the fact that the supplier is a party to the multilateral contract with, *inter* alia, the card issuer, regulating payment.) The considerations may include the following (both for the "test" in the *Reigate* case and the requirements for a custom in terms of *Golden Cape Fruits (Pty) Ltd v Fotoplate (Pty) Ltd* 1973 2 SA 642 (C) 645H; of course these considerations will not be applicable in all circumstances): the extent to which a specific method of payment is used, both generally and with reference to the specific type of transaction; security considerations; the amount concerned (*cf* Proctor 75-76); the question whether banking details were supplied (Proctor 185 n 37; *cf* art 6.1.8(1) *Unidroit Principles*) and the general reluctance to use cash with reference to money laundering and the financing of terrorism: "substantial cash transactions are inherently suspicious" (Proctor 76 fn 58, 184). Geva (26 fn 71) states:

> "It is, however, possible nowadays, for either fiscal and anti-crime reasons, to have cases where it is required that certain payments, usually above a specified ceiling, are to be carried out by means of a payment mechanism and not in cash."

There is, however, one consideration in South Africa that will often indicate that at least one of the parties expect a transaction to be concluded with notes and coins, and that is the idea of financial inclusion. Any move away from cash, may not make it more difficult for anyone to pay. Such concerns may, for example, be remedied in future within the development of payment methods such as mobile money.

6 *Conclusion*

The concept "cash" may, depending on the context, include "anything that is regarded in commerce as equivalent to cash" (*Esterhuyse* 362). In *Tenax Steamship Co Ltd v Reinante Transoceania Navegacion SA (The Brimnes)* (1973 1 WLR 386) the meaning of payment in cash is interpreted "against the background of modern commercial practice" as "any commercially recognised method of transferring funds the results of which is to give the transferee the unconditional right to the immediate use of the funds transferred" (400; approved on appeal in *Tenax Steamship Co Ltd v The Brimnes (Owners)* 1975 QB 929 948G-H, 963F and 968H ("It would be absurd in modern business conditions to suppose that payment in dollar bills was contemplated ...") and in *Mardorf Peach & Co Ltd v Attica Sea Carriers Corp of Liberia* 1976 1 QB 835 849 *et seq*). It is not even necessary to talk of a "robust process of interpretation" to arrive at such a result (see Proctor 184).

A credit transfer (in the traditional sense) can be made, in principle, by any person with a bank account. It is therefore submitted that a completed payment by credit transfer can be regarded as the commercial equivalent of cash. One should not underestimate the inherent flexibility of mercantile law, based on private law; the *lex mercatoria* has always been able to adapt to changing circumstances. Geva wrote:

> "The chances are that the evolving new global and transnational 'law merchant' governing payment transactions will remain anchored in the legal doctrine of Antiquity and the Middle Ages. At the same time, this 'law merchant' will not only advance, but will also become more harmonized. It will thus evolve to accommodate not only emerging new diverse technologies, but also a truly global payment system, shared by all people of this planet" (641).

The existence of a "truly global payment system" may not quite be within our reach yet, but custom has always played an important role in banking law; one should be able to contend that new forms of money – at least within the borders a specific country – may be recognised by custom (*cf* Malan Pretorius and Du Toit 6-7, also fn 47 regarding negotiable instruments; *cf* Proctor 42). Private law is furthermore, taking into account modern banking practice and technological advancements, able to ensure payment takes place in a way that is fair to both debtor and creditor, even against the background of section 17 of the South African Reserve Bank Act, which is looking somewhat dated these days.

Corruption poses a threat to the financing of sustainable infrastructure projects – what can be done against It?

Dr Marc Leistner: Deputy Head of Regional Representation for Southern Africa and Indian Ocean, European Investment Bank (EIB)[1]

Introduction

The European Investment Bank (EIB)[2] is the long-term financing arm of the European Union. Its Head Office is in Luxembourg, the 28 Member States of the EU are its shareholders, and it is a not-for-profit institution. Rather than the maximisation of profit, its purpose is to support the policy of the EU through the long-term financing of sustainable projects, in the first instance large[3] infrastructure projects. In addition to the latter, EIB also provides credit lines to financial intermediaries for on-lending to SMEs or micro-enterprises, again for sustainable projects. Whilst about 90% of EIB's activity takes place within the EU, the 10% of new financings that the Bank provided outside the EU in 2014 corresponded to some EUR 8 billion (ZAR 100 billion), of which approximately EUR 1 billion (ZAR 13 billion) in sub-Saharan Africa. These operations fall under the overall mandate for sub-Saharan Africa[4], given to the Bank by the EU, which is to finance sustainable projects that promote development. Rather than focusing on the *financial* aspects of the transaction, it is therefore the *project* being financed which is at the centre of EIB's attention.

What are sustainable projects? Certainly not projects that are over-priced, whose dimensions far exceed the needs, whose quality does not allow full exploitation of their purpose in scope or in time, or which have disproportional negative environmental and social effects. While such non-sustainable characteristics may often be due to a lack of skills or experience, they can equally result from a practice that in some cases requires some skills of its own, namely corruption. In the narrow sense, corruption is sometimes defined in relation to the public sector. E.g., Corruption Watch defines corruption as "the abuse of public resources to enrich or give unfair advantage to individuals, their family or their

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[1] The EIB's Regional Representation for Southern Africa and Indian Ocean is located in Pretoria. The author acknowledges with thanks the contribution from various colleagues at EIB's Head Office to this article. A word of special thanks is due to Mr Patrick Hugh Chamberlain, Associate Director, Legal Directorate, and Mr Duncan Smith, Deputy Head of Fraud Investigations, Inspector General's office.

[2] Not to be confused with the European Central Bank.

[3] Total project costs should normally be at least EUR 40 million (ca. ZAR 520 million), of which EIB could then in principle finance up to 50%.

[4] Strictly speaking two mandates, i.e. the so-called "External Mandate" (covering *inter alia* South Africa) and the Cotonou Agreement mandate (under which the remaining sub-Saharan countries fall).

friends".[5] However, corruption in the wider sense extends also into the private sector. A wider definition is offered by Transparency International, i.e. "Corruption is the abuse of entrusted power for private gain."[6] Similarly, EIB's Anti-Fraud Policy[7] defines corrupt practice as "the offering, giving, receiving, or soliciting, directly or indirectly, anything of value to influence improperly the actions of another party". As is clearly set out in the Bank's Anti-Fraud Policy, EIB has a zero tolerance policy when it comes to fraud and corruption.[8]

Large infrastructure projects present numerous opportunities for corruption. However, where corruption is rife, it is a challenge to put in place sustainable projects. Phrased differently, in order to implement sustainable projects, corruption has to be excluded or at least reduced to a minimum.

Indeed, it is difficult to exclude the risk of corruption completely, in the same way that it is not possible to guarantee absolute personal safety in an environment of violent crime. In the context of the latter, reference is commonly made to "rings of safety". Every single precaution or protective measure constitutes a ring, and the more such rings you have, the less likely you are to become the victim of violent crime. The same applies to corruption: the more rings of precaution or protection you have, the better.

I do not purport to have a magic answer on how to get rid of corruption in general. Regardless of country or society, corruption is always a risk, sometimes more, sometimes less. It requires well established procedures of good governance, that are filled with life, as well as permanent vigilance. In the following, I would like to focus on some of the measures that a bank can – or should – take in order to reduce the risk of corruption when financing a project.

As every banker will know, and more so every engineer, the implementation of infrastructure projects passes through various stages, including concept stage, project preparation, project approval, procurement, contracting, disbursement, construction, operation and monitoring. In order to minimise the risk of corruption, the protective rings referred to above must apply to every singly stage. I would like to deal with them in

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[5] http://www.corruptionwatch.org.za/content/what-corruption

[6] https://www.transparency.org/whatwedo

[7] "Policy on Preventing and Deterring Prohibited Conduct in European Investment Bank Activities" dated 17 September 2013 as published on EIB's website. To be noted that the definition of "corrupt practice" as cited in the text above is taken from the "Uniform Framework for Preventing and Combating Fraud and Corruption", agreed in September 2006 by the leaders of seven major International Financial Institutions. In addition to EIB, these were the following: African Development Bank Group, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Group, International Monetary Fund, and World Bank Group.

[8] This is underscored also by the EIB Whistleblowing Policy which obliges EIB staff members to report any suspected incidents of fraud or corruption. Bank staff are required to undergo increased training to enhance their ability to spot potential red flags.

chronological order, in line with the development cycle of a typical infrastructure project as financed, or considered for financing, by the EIB.

Request for financing

When the bank receives a request for financing, it must have clarity on the identity of the project promoter and of the prospective borrower of the Bank's funds[9]. While this seems simple, the reality is sometimes less so. Complicated shareholder structures often obscure the identity of those that drive the policy of the promoter / borrower, and sometimes even minority shareholders sway more influence than may appear at first sight. It is therefore essential for the financing institution to insist on full transparency regarding the identity of its potential partners, including the structures within which these potential partners are embedded and which would therefore influence their behaviour.

In this regard, banks often refer to the requirement of "KYC", in full: "Know Your Client". Where a long-standing relationship already exists, this will generally be relatively easy, but in the case of a new client, great care needs to be taken to get to know the potential client and its practices. This includes also the environment within which the potential client operates. E.g., special care needs to be taken where an entity is located in country that features in the "List of Prohibited and Monitored Jurisdictions" of the FATF[10], as this would typically indicate a weakly regulated, non-transparent and uncooperative jurisdiction. Similarly, the degree of tax compliance of a particular jurisdiction as per the classification of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes ("OECD Global Forum")[11] needs to be taken into account when assessing a potential client.

While all banks will to some extent apply KYC and Anti-Money Laundering procedures when establishing a financing facility, EIB will go further by examining the jurisdiction of the place where the project promoter is established. Non-transparent jurisdictions which offer low or non-existent tax rates and allow concealment of the ultimate beneficial ownership of entities established there face obstacles in obtaining EIB financing when they are badly rated by so-called Lead Organisations such as the FATF and OECD Global Forum. Individuals or entities that shelter behind these sorts of jurisdiction are precisely those most likely to condone or connive at corruption. However their involvement

[9] Promoter and borrower will often be identical, but this is not necessarily the case.

[10] The FATF ("Financial Action Task Force") was created at a G-7 summit in Paris in 1989, with the primary objective of coordinating an international response to money laundering. In the wake of 9/11, it also introduced special recommendations against the financing of terrorism.

[11] This classification focuses on addressing the risks to tax compliance posed by jurisdictions concerned.

can produce the effect of disqualifying a project from EIB consideration at the outset and on the principle that prevention is better than cure we believe that a corruption risk is avoided as a result.

Project preparation

For any sizeable infrastructure project, EIB will normally require a feasibility study to be submitted to the Bank. As the word suggests, this study must demonstrate that the project is feasible, having regard to technical, financial, economic, environmental and social aspects. If the study is faulty or fraudulent, there is a risk of embarking on a project on the basis of incorrect assumptions that can lead to wasted expenses and an unsuccessful project. It is therefore essential that the study be conducted in a proper, competent manner, meaning also that it should be as objective as possible, i.e. not slanted by personal interests.

In order to ensure competence and objectivity, the choice of consultant or other party to perform the study is key. It is normally useful to conduct a tender for this purpose. Equally important, however, is the evaluation of the study, i.e. assessing whether the facts and assumptions underlying it are indeed feasible. It is here that the European Investment Bank can make a major contribution: The EIB has a large technical directorate, comprising sector economists and sector engineers, e.g., in the water sector, in the renewable energy sector, in road and rail, in airports, in telecoms, in the agricultural sector, etc.

These sector specialists are involved in EIB operations world-wide and can therefore draw from a wealth of experience when assessing a particular operation. Accordingly, they are well placed to evaluate feasibility studies: If the technical solution presented is not optimal, they are likely to spot it. The same applies, if the estimated costs are excessive, or too low. In such cases, or in the event of any other inconsistencies arising from the feasibility study, they will voice their concerns and this will result in a discussion with the project promoter. If not satisfactorily explained, the concerns would need to be adequately addressed, or alternatively the Bank may decide not to pursue the project any further. While of course not all inconsistencies can be attributed to corruption, feasibility studies – and project preparation in general – are an area where special vigilance is required and where in-house technical expertise, such as that of EIB, is an important "ring" contributing to preventing corruption and its possible negative effects, e.g., excessive costs.

Due diligence and internal approval

EIB has a dual approval process: once it has been established that both the counterpart[12] and the envisaged project would in principle be acceptable for EIB financing, an internal Project Information Note (PIN) is then submitted to the Bank's management for approval of

[12] Promoter / prospective borrower.

the concept of the operation. Such approval, if given, triggers a more detailed analysis of the project, the so-called due diligence, of which the appraisal mission forms an important part: An EIB appraisal team would usually travel to the country where the project is located, in order to get a better understanding of the technical, financial, economic, environmental and social aspects of the project. This involves a site visit at the proposed project location as well as in-depth discussions on the envisaged project with the promoter and other relevant stakeholders.

The EIB appraisal team typically consists of a sector engineer, a sector economist, as well as the responsible loan officer. Together, they are well equipped to probe the rationale of the project, the proposed technical solution, the project's economic justification, its financial viability, the envisaged procurement process, the promoter's implementation capacity, etc.

The appraisal exercise as described above is complemented by further analysis of the proposed project by the Bank's credit directorate, the legal directorate and the Office of the Chief Compliance Officer (OCCO). In addition, both the government of the country where the project is located, as well as the European Commission, have to confirm in writing that they do not object to the project.

Subject to a satisfactory outcome of the due diligence process, an internal report is compiled and then submitted to the Bank's governing bodies[13] for approval of the operation. Amongst other things, approval requires that the envisaged co-financiers of the operation have been identified; these should also include the promoter himself, who should normally contribute some own funds to the project so as to share at least part of the project risk.

EIB's approval process as set out above involves a thorough screening and other safeguards against abuse and can therefore contribute substantially towards uncovering corrupt practices.

<u>Procurement</u>

Procurement relates to the way in which the providers of works, goods and services are identified. It represents an area of particularly high risk of corruption, as it can be very tempting for some promoters to allocate contracts to those who offer personal favours rather than those that provide the best quality at the best price. EIB therefore applies a strict procurement policy as embodied in its Guide to Procurement[14]. The latter is based on the main mechanisms of the EU Directives of procurement.

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[13] Normally the Management Committee and, subject to its endorsement, the EIB's Board of Directors. The latter comprises representatives of the EU Member States as well as from the European Commission.

[14] http://www.eib.org/attachments/thematic/procurement_en.pdf

Where a public sector project is concerned, EIB requires open, international tendering, thus allowing for world-wide competition. The same applies where a private sector project is based on a public sector concession, e.g., power projects or railway projects that are implemented by the private sector on the strength of a concession granted by the public sector. The concession itself should also be allocated on the basis of international, open tendering. Generally, procurement must ensure non-discrimination of tenderers, fairness and transparency of the process, and selection of the economically most advantageous offer.

In the case of a purely private project, not based on any public concession, the Bank's procurement rules are somewhat more flexible than where there is public sector involvement. This is because it is assumed that the private sector, in its own interest, will ensure that the best quality at the best price is achieved.

EIB's technical experts can assist the promoter, free of charge, in giving input on tender documents and having the tender published in the Official Journal of the European Union (OJEU), thereby ensuring open international tendering. As a general rule, the Bank will in countries outside the EU require that promoters insert in the tender documents a clause that requires any tenderer for works, goods or services, as a condition of admission to eligibility, to execute and attach to its tender a Covenant of Integrity in a specific format as contained in an annex to EIB's Guide to Procurement.

EIB will not participate in evaluating the tender, however the Bank's responsible engineers will closely review the evaluation report in order to verify that the evaluation has taken place in line with the provisions stipulated in the tender document. A non-objection from EIB on the evaluation report is required before the promoter may enter into any contract that is to be financed by the Bank.

Application of EIB's procurement policy thus serves as an important "ring" in combating corruption and ensuring that the funds lent by EIB are not misused or misapplied.

EIB Finance Contract

An audience like this needs no reminding from me of the difficulties inherent in trying to modify human behaviour by means of the operation of legislation or by contractual incentives and penalties. You will also be hearing shortly from the next speaker about the particular terms of the Loan Market Association (LMA) documentation as it is applied in developing markets.

EIB uses a loan document that shares many of its features with commercial and DFI[15] term lenders alike but I would like to draw out some themes from it with regard to the points that can assist in controlling corruption.

[15] Development Finance Institution.

As we have just discussed, the signature of the finance agreement will follow an appraisal process that we believe would delineate where the corruption risks in a particular project may be most likely. However the process of tendering and actual acquisition of goods and services occurs on a time continuum starting before and continuing through signature, disbursement and the early life of the loan. It is thus important that our conditions of disbursement allow checking and rechecking on each occasion that funding leaves the Bank, so that the amount and purpose of the disbursement is as little exposed to corruption as we can make it.

Thus in relation to project expenditures, a dedicated team of EIB staff will be examining actual cost invoices for their conformity to the contract first approved by EIB under the tendering process and whether they conform to our expectations. Because EIB finances infrastructure projects in 28 EU countries and more than 120 other jurisdictions worldwide, our engineering staff are well aware of what the fixed assets should cost and the time and civil engineering processes needed to build them.

In cases where EIB finances the project on its own risk rather than via a sovereign intermediary, the additional practice is for the lenders to retain an independent consulting engineer to certify conformity with the contractual milestones that the original project diligence identified as important.

Let me also point out one of the values of the co-financing that applies to the majority of the EIB financings combined with the *pari passu* nature of disbursement between lenders. Because the EIB Statute prevents the organisation from financing more than 50% of the cost of any project, the necessary participation of a co-financier - often another supranational or local development bank -, brings in a control by means of the four-eyes principle. If our co-financier holds back disbursement for lack of satisfaction with the conditions of disbursement, so would EIB. And the reverse applies as well: if EIB is not satisfied that its conditions of disbursement have been properly fulfilled, the project promoter will likely find that his entire lending stream has dried up until the matter is resolved to the lenders' satisfaction.

While we are discussing coordination among lenders we can step out of the loan financing time line for a moment to mention cross-debarment. As you probably know, development organisations, notably the World Bank, but also the European Union, maintain registers of commercial or other parties whose behaviour in relation to a particular project or activity has caused them to be listed as infringing the corruption codes of the organisation concerned. It is now common practice both before loan signature and during a loan disbursement for development lenders to cross-check each other's debarment registers. The decision taken by one development lender to debar a particular entity can result in immediate disqualification by the other development lender if there is a formal cross-debarment agreement between them or would trigger investigation by the second lender pursuant to its anti-corruption or ethical policies, necessarily interrupting any financing from the second lender.[16]

Reverting to the time line of the typical EIB financing, controls continue in the post-disbursement phase. Like all term lenders, EIB's agreement contains information requirements, ongoing representations and warranties, behavioural covenants and events of default all of which can be applied throughout the loan life.

As described earlier these will include provisions which go beyond Equator principles and which reflect our ongoing dialogue with the EU Member States who are our shareholders, the European Parliament and the NGO community.

To take an example, a tendering process approved by EIB will require the tendering parties to retain records for a period of at least 6 years from the date of substantial performance of the contract, and the EIB finance agreement will reserve rights to investigate those records and to interview the involved parties by the EIB's own fraud investigation team and/or the EU's OLAF fraud investigators. This is a right that can and has been used in countries well beyond the borders of the EU to examine on an ex-post basis where the money went and consequently determine whether this was the intended and satisfactory outcome.

EIB retains contractual rights to visit its financed projects and interview interested parties, and the Bank is staffed with engineers and a complaints team to exercise these rights.[17] Thus it is that third parties who may typically have local knowledge and who suspect corruption or indeed other ills like child labour or botched population resettlement are able to trigger a chain of contractually-specified events and actions performed by EIB which is an organisation of no particular national or political affiliation. These actions may or may not result in a proven event of loan default in terms of the EIB financing but the incidental and perhaps more valuable outcome is that they undoubtedly set up a publicly identifiable issue and a visible need for governance well beyond the particular loan relationship.

[16] EIB has not signed up to the " Agreement for Mutual Enforcement of Debarment Decisions" signed by some Multilateral Development Banks in April 2010, however can use its Exclusion Procedures to exclude individuals or entities who have engaged in fraud or corruption from participating in EIB-financed projects or operations.

[17] E.g., a borrower subject to allegations of corruption may be required to undergo a forensic review and implement a fraud risk management plan. Other, more general measures could include, e.g., publication in newspapers of implementation schedules so that the public can monitor developments in projects and report suspicious delays.

Conclusion

As stated at the outset, corruption poses a threat to the sustainability of infrastructure projects. Where public infrastructure is of a lesser quality as a result of corrupt practices, or where such practices make public infrastructure more expensive than it should be, it is the consumer who suffers – either through sub-optimal service delivery, or through extra costs in terms of taxes or tariffs. Similarly, where the quality of a private sector infrastructure project is below standard, it is the public at large that is at risk. Sometimes this can even lead to loss of life, e.g., where corrupt practices detrimental to quality assurance result in ceilings falling down or buildings collapsing.

In addition, corruption also threatens sustainable economic development as a whole, in that it provides an incentive to strive for personal gain at the cost of the public good, disregarding ethical values for serving society as a whole. Once such a distortion of values has taken place, it is of course very difficult to correct it. The tone from the top is always important in setting the integrity agenda, but sometimes even this is not enough to change a practice that may have become entrenched.

Because banks play a central role in the economy, they can contribute greatly to combating corrupt practices by applying strict standards.

I believe that the European Investment Bank (EIB) is well equipped to contribute to the fight against corruption, due to its extensive, world-wide experience in financing sustainable infrastructure projects and, notably, due to its substantial in-house technical knowledge and control mechanisms. The above text illustrates the measures that the Bank is taking to help ensure that every step in the project cycle is performed in a responsible way.

Naturally, the application of these measures in practice requires constant watchfulness, as well as the ability and willingness to follow up on any fact or constellation that is not plausible. Criminals and organised crime are very quick to exploit potential weaknesses in policy frameworks and procedures. It is also with this in mind that EIB's staff undertaking investigations work do so in close cooperation with the European Commission's investigation function OLAF and counterparts at other International Financial Institutions such as World Bank and African Development Bank.

Banks – and notably Development Finance Institutions such as EIB – are often accused of asking too many questions, of being complicated, of not paying out money quickly enough. While one may have sympathy for this perception, the above text has also shown how much can go wrong and how many avenues need to be checked in order to provide maximum comfort that a project will indeed be sustainable and that corruption will not jeopardise sustainability.[18]

As stated earlier in the text, there can be no absolute protection against corruption, however the "rings" being put in place by EIB in its operations go a long way towards minimising corrupt practices. In fact, this is one of the reasons why the participation of EIB in the financing of a project gives comfort to other stakeholders. EIB's involvement in a project often acts as a catalyst for other financiers to also come on board.

What needs to be borne in mind at all times, however, is that the fight against corruption cannot be reduced to putting in place measures that "catch out" culprits. Rather, efforts must focus on instilling a culture of values that is strong enough to maintain clean, transparent practices at all times. In the long run, only well anchored, coherent values of good corporate governance will ensure sustainability. Through the long-term nature of EIB's financing and therefore of its interaction with the borrower/promoter, I believe that EIB, in supporting sustainable infrastructure projects, is indeed making a substantial contribution in this broad sense to the fight against corruption.

[18] It needs to be remembered also that Development Finance Institutions such as EIB are public institutions that are ultimately accountable to their shareholder governments.

Withholding tax on interest in South Africa

Thabo Legwaila

1 *Introduction*

In 2012 the then South African Minister of Finance Pravin Gordhan announced the introduction of the Withholding Tax on Interest (hereinafter referred to as "the WHTI" in the 2012 Budget Review. Originally, it was to come into effect on 1 April 2014. The date had been postponed to 1 January 2015 and then to 1 March 2015 due to the technical and administrative details and requirements attached to the levying of the tax. The WHTI finally came into effect on 1 March 2015 and applies to any interest paid on or after that date. Thus, it applies to any interest paid on or after 1 March 2015 regardless of the fact that the arrangement giving rise to the interest payment was entered into, came to force or was backdated to a date, before 1 March 2015.

Interest is taxable under normal rules of tax. Interest forms part of gross income of a taxpayer as an amount in cash received by or accrued to a taxpayer that is not of a capital nature.[1] Such interest is taxable if it is received or accrues to a person that is a resident. If the recipient of the interest or the person to whom the interest accrued is not a resident as defined, such interest is exempt from tax in terms of section 10(1)(h) of the Income Tax Act 58 of 1962 (hereinafter referred to as "the Act").[2] At the outset this it is important to explore the nature or character of interest in order to contextualise the subject of this paper.

2 *Definition of interest*

The WHTI applies to interest that is paid by a resident to a non-resident. The Act does not define interest as a general matter. This means that interest that is subject to the WHTI is interest in the ordinary or common law sense of the word. In general interest is understood to be an amount charged by a lender for the use or detention of money.[3] The definition of interest is specific to section 24J the purpose of which is to determine the incurral and accrual of interest. The section 24J definition of interest is much broader than the literal meaning of interest. In terms of section 24J "interest" includes the following:

> (*a*) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

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[1] Interest is an amount received or accrued for the employment of capital and is generally accepted to be of a revenue nature. See Croome, Oguttu, Muller, Legwaila, Kolitz, Williams and Louw *Tax Law: An Introduction* (2013) at 84.

[2] Unless otherwise stated, references to sections and Parts in this paper are references to the sections or parts of the Act as the case may be.

[3] See IBFD International Tax Glossary definition of "interest".

> (*b*) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
> (*c*) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,
> irrespective of whether such amount is—
> (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or
> (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement;

The differences between interest to which the withholding tax applies and the interest to which section 24J applies can be attributed to the fact that section 24J determines the incurral and accrual of interest with a specific purpose to curb the avoidance of tax by taxpayers *inter alia* expatiating the incurral of interest for the lender and delaying the accrual of the interest by the borrower.

As will be seen later in this article, the WHTI can be reduced by application of DTA between SA and the country of residence of the borrower. Even though South Africa is not a member of the OECD, South Africa's DTAs follow the OECD Model Convention. The treaties generally exempt interest from the WHTI. These treaties contain a definition of interest and they generally define interest as follows:

> "The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."[4]

While this Model Treaty definition may seem extensive in its application, its specific references do not extend nor deviate from the literal definition of interest, let alone limit the definition. In effect if it was of a more limited application than the general or literal definition of interest as contemplated in section 50B, it would pose problems as some interest would not be covered by treaty relief. Conversely, if it were broader, it would apply to certain items that are not subject to the WHTI, and perhaps extend to provide treaty relief to items that are not subject to tax in terms of the WHTI regime.

3 *Exemption of interest from normal income tax*

In terms of section 10(1)(h) interest is exempt from WHTI if the interest is earned by a person that is not resident unless that person is a natural person that has been physically present in South Africa for a period of 183 days or more in that year of assessment, or if the interest is earned by a person other than a natural person and the interest is attributable to a

[4] See Article 11(3) of the OECD Model Tax Convention 2014,.

permanent establishment that such person has in South Africa. As will be seen later, if the natural person has been physically present in South Africa for a period of 183 days or more, or it is attributable to a permanent establishment of a non-resident in South Africa, such interest will be subject to the WHTI in terms of Part IVB of the Act.

In effect therefore, section 10(1)(h) exempts from normal income tax interest that is subject to the WHTI. It is not clear why the legislature opted for a long version of the exemption as opposed to a shorter and more direct wording that states “there shall be exempt from tax any interest paid to a non-resident if that interest is taxable in term of Part IVB”. Interestingly, this is the wording that the legislature employed in section 10(1)(hB) in exempting service fees that are taxable in terms of the withholding tax on services regime provided for in Part IVC of the Act.

Several observations can be made from this exemption. Firstly, taxing interest that is earned from a South African source by a person that is not a resident presents challenges of enforcement. South Africa does not generally have jurisdiction to enforce South African laws on non-residents. Secondly, even if South Africa had such jurisdiction for example in terms of an extradition treaty, the costs of such enforcement would be great in relation to the benefit derivable from such enforcement. Thirdly, the exemption of interest sourced in South Africa deprives the South African fiscus of South African sourced income to which South Africa should have a primary taxing right. Fourthly, the self-deprivation of the taxing right by South Africa appeals to investors only to a minimal level as the country of residence of the investor then assumes the full taxing right to the interest and as such neutralizing the positive effects that South Africa may derive from exempting interest earned by a non-resident from tax. Fifthly, the unequal treatment of residents vis-à-vis non-residents created an uncomfortable political vulnerability of the South Africa tax system that could result in tax driven business and economic investment practices adverse to the SA economy. Finally, and most importantly, South Africa levies withholding taxes on royalties and dividends.[5] With interest payable to non-residents not taxable at all, investors would be tempted to re-characterise royalty or dividend payments to non-residents as interest to benefit from the tax free treatment. This not only creates an undesirable situation where the different tax treatment of different instruments unduly influences the business practices, but also imposes an increased and anomalous anti-avoidance administrative burden on the SARS. These are some of the many reasons why the South African government introduced the WHTI.[6]

[5] The withholding tax on service fees will come into effect on 1 January 2016.

[6] See National Treasury Explanatory memorandum on the Taxation Laws Amendment Bill (10 December 2012) at 119 and National Treasury Explanatory memorandum on the Taxation Laws Amendment Bill (24 October 2013) at 75.

4 *Levying and liability of WHTI*

The WHTI is levied on interest paid to a non-resident or that is due and payable to a non-resident. A non-resident is a person that is not resident in South Africa. Resident is defined in section 1 of the Income Tax Act as a natural person that is ordinarily resident in South Africa[7] or that satisfies the physical presence test in South Africa.[8] In relation to persons other than natural persons a person is resident if it is established, formed or incorporated in South Africa or has its place of effective management in South Africa.[9] A person that does not fall under this definition is a non-resident and therefore liable to the withholding tax. The charging provision for the WHTI is section 50B(1) which provides as follows:

> There must be levied for the benefit of the National Revenue Fund a tax, to be known as the withholding tax on interest, calculated at the rate of 15 per cent of the amount of any interest that is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9 (2) (*b*).

The WHTI is not a tax *per se*. It is an administrative mechanism to collect the tax from the person who receives interest, or to whom interest accrues if that interest is from a South African source. Thus, the liability for the tax on interest is on the recipient or payee of the interest. In this regard, section 50C(1) provides that “[a] foreign person to which an amount of interest is paid is liable for the withholding tax on interest to the extent that the interest is regarded as having been received by or accrued to that foreign person from a source within the Republic in terms of section 9 (2) (*b*).

However, as stated above South Africa does not have jurisdiction over non-residents therefore it would be administratively burdensome for SA to collect the tax on interest due by non-residents. The administrative solution to this problem is in the form of a withholding tax. While the liability for the tax is on the recipient of the interest, the Act placed the administrative burden, in terms of calculation and collection to the resident paying the interest. This is primarily because the SA government has jurisdiction over the resident payer of the interest. This is achieved through the provisions of section 50E(1) which provides that “[s]ubject to subsections (2) and (3), any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest calculated at the rate contemplated in section 50B (1) from that payment”. In terms of section 50C(2), where any amount of withholding tax on interest is

[7] Section 1 para (a)(i) of the definition of residence. See Robinson v COT 1917 TPD 542, 32 SATC 41; Cohen v CIR 1946 AD 174, 13 SATC 362; Nathan’s Estate v CIR 1948(3)SA 866 (N), 15 SATC 328; H v COT 1960 (2) SA 695, 23 SATC 292; CIR v Kuttel 1992 (3) SA 242 (A), 54 SATC 298.

[8] Section 1 para (a)(ii) of the definition of “residence”.

[9] Section 1 para (b) of the definition of “residence”.

withheld[10] and paid[11] that amount of withholding tax on interest is regarded as an amount that is paid in respect of that foreign person's liability.

5 *Rate of WHTI*

The WHTI is leviable on any interest paid to a non-resident at the rate of 15%. This rate is lower than the 28% flat corporate income tax rate. While the 15% rate may at first sight seem low and favourable, it should be noted that the15% rate is applied to the gross amount of the interest paid, and not the net amount of exemptions and deductions attributable to normal income subject to the 28% corporate income tax. Interest is deemed to be paid on the earlier of the date on which the interest is paid or becomes due and payable. The WHTI is a final tax.

6 Tax relief

The WHTI is a direct tax on the recipient of the interest withheld at the level of the payer of the interest. What this practically implies is that the payer will deduct the amount of the WHTI from the amount of the interest paid. It is not a tax on the net amount paid as interest, i.e. it is not paid over and above the amount of the interest. For example if the amount of the interest is R 100 000, the payer will for accounting purposes expense the full R100 000 but pay the recipient R 85 000 and pay the remaining R 15 000 to the SARS on behalf of the recipient. The recipient would therefore receive the R85 000. The recipient would then account for tax in their jurisdiction on the R100 000. If the country of the recipient does not provide the foreign tax relief, and there is no DTA in place that provides for the relief from double taxation, the recipient would then account for tax on the R100 000. A variation of the amount could result from the imposition of tax only on the amounts actually received similar to the blocked funds exclusion in section 9A of the Act.[12]

The situation would be different if the foreign country provides for relief against double taxation. Such relief could be provided in one of three forms: exemption, credit or deduction.

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[10] As contemplated in section 50E (1).

[11] As contemplated in section 50F (2).

[12] Section 9A(1) provides that [w]here any amount, or any portion of any amount, received by or accrued to any person which is required to be included in the income of that person during any year of assessment may not be remitted to the Republic during that year as a result of currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose, that person shall be allowed to deduct from his or her income for that year an amount equal to so much of the amount or portion which may not be remitted as is required to be included in the income of that person for that year".

- In terms of the tax credit system a recipient would not be taxable on the amount of interest earned from South Africa. The effective tax payable by the recipient in this regard would be the 15% paid in South Africa. This in the example above, the recipient would pay a total tax of R15 000.
- In terms of the tax credit system the recipient is credited for the amount of tax paid in the other country, i.e. South Africa. Thus, in the above example the recipient would account for tax on the full R100 000 and once his tax liability on the R100 000 is determined in terms of the local laws of the foreign country the R15 000 would be credited which in effect means that his tax liability would be reduced by the R15 000.
- In terms of the tax deduction system the recipient is allowed a deduction of the amount of tax paid in the source country. The recipient then accounts for the tax on the net amount received. Thus, in the above example, the recipient would account for the tax on the R85 000.

7 *Grossing up*

As has been seen the WHTI reduces the amount of interest received by the recipient. If no double taxation relief method is available for the recipient the WHTI could disastrously affect the recipient of the interest. In order to eliminate the adverse effects of the WHTI, investors provide for a gross up clause in their international contractual terms. The gross up clause indemnifies the recipient from the withholding tax by contractually placing the liability of the tax on the payer of the interest. It ensures that the recipient receives the full amount of the interest. This increases the amount of the interest that the payer expenses.[13] Using the above example, the grossing up clause would result in the interest being calculated at about R118 000. This would result in the WHTI of about R18 000 and net interest paid to the recipient of R100 000.

Grossing up clauses are applied both where there is no double taxation relief and where there is relief. Where there is double taxation relief, the payer is required to gross up the amount if the payer fails to assist the recipient with the formal requirements by the foreign country that should be provided by the source country for example tax certificates proving that the WHTI has been paid in the source country. Two observations can be made at this stage, firstly that the WHTI does not prohibit or regulate the use of grossing up clauses. Secondly, the fact that the payer has grossed up the amount does not prohibit the recipient from claiming the foreign tax relief where it is provided. The latter instance could

[13] For accounting purposes "expense" is a term used to describe the costs associated with the day-to-day normal operations of a business. See Who Owns Whom Dictionary of Securities Market Terms 2009 definition of "expense".

result in the recipient doubling up on the benefit of the tax gross up clause by receiving the gross amount of the interest and claiming the foreign tax credit on the grossed up amount.

8 *The withholding liability*

It is important to distinguish between the liability for the tax on the recipient and the administrative liability to withhold and pay the tax to the SARS that rests with the payer of the interest. The payer and the recipient are jointly and severally liable for the tax in that both can be practically compelled to pay the amount and that payment by the either the payer or the recipient absolves the recipient or the payer, as the case may be, from the liability of the tax.

The liability to withhold on the part of the payer of the interest is provided for in section 50E which states that **"…**any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest." On the other hand the liability for the tax on the recipient of the interest is provided for in section 50F which states that "[i]f…a foreign person is liable for any amount of withholding tax on interest in respect of any amount of interest that is paid to or for the benefit of the foreign person, that foreign person must pay that amount of withholding tax by the last day of the month following the month during which the interest is paid, *unless the tax has been paid by any other person*" (my italics). The italised words indicate that if the payer of the interest withheld and paid the WHTI to the SARS, the recipient is absolved from the payment of the WHTI. The Act does not expressly provide for a relief for the payer for instances where the recipient pays the withholding tax and the payer does not withhold. On the strict reading of the WHTI provisions, the payer remains liable to withhold even if the tax had been paid. The WHTI provisions do not provide to the effect that if the recipient of the interest pays the WHTI, the payer id deemed to have paid and therefore the payer's liability to withhold is extinguished.

9 *Exemptions*

Section 50C provides for exemptions from the WHTI. These exemptions are based on the person paying the interest as opposed to the recipient of the interest, the nature of the instrument giving rise to the interest or any other possible distinguishing factors. Section 50C exempts interest paid by (1) the government of the Republic in the national, provincial or local sphere;[14] (2) any bank, the South African Reserve Bank, the Development Bank of Southern Africa or the Industrial Development Corporation;[15] or (3) a headquarter company

[14] Section 50D(1)(a)(i)(aa)

[15] section 50D(1)(a)(i)(bb)

in respect of the granting of financial assistance.[16] Because the interest is paid by the entity giving rise to the exemption, no further requirements are to be met in order to access the exemption. In this regard section 50E(2)(a) merely provides that “[a] person must not withhold any amount from any payment contemplated in subsection (1) to the extent that the interest is exempt from the withholding tax on interest in terms of section 50D (1)”.

9.1 The government of the Republic in the national, provincial or local sphere

Interest paid by the government of the Republic in the national, provincial or local sphere is exempt from WHTI. This would typically be interest paid on government bonds and similar instruments issued by the government. It is trite that the WHTI is aimed at curbing the avoidance of tax by re-characterising income and to bridge the gap in the tax treatment of interest for residents and non-residents. With regards to interest on government bonds, the tax treatment of residents and non-residents remains different. While non-residents are exempt from the WHTI, residents do not have any relief from tax on interest paid by the government of the Republic in the national, provincial or local sphere.

9.2 Banks and branches of banks

With regards to the exemption on interest paid by a bank, the original definition of a bank in the Taxation Laws Amendment Act of 2013[17] provided that a “bank means any bank as defined in section 1 of the Banks Act.[18] The reference to "bank" as defined in the Banks Act presented technical challenges for branches of foreign banks. Branches of international banks (hereinafter referred to as "international banks") operating in South Africa are the following: AlBaraka Bank Ltd, Bank of China Johannesburg, Citibank N.A, Deutsche Bank, Bank of Taiwan, China Construction Bank, HBSC Bank PLC, JP Morgan Chase Bank, Mercantile Bank, Societe Generale JHB Branch, State bank of India and Bank of Athens. These international banks are all members of the International Bankers Association as on 11 March 2015. Section 1 of the Banks Act defines "bank" as follows “bank” means a public company registered as a bank in terms of this Act. International banks are not public companies and are not registered as banks in terms of the Banks Act.

International banks generally operate under license in terms of a “Certificate of Authorization for the Conducting of the Business of a Bank by a Foreign Institution by means of a Branch in South Africa” granted by the South African Reserve Bank in terms of section

[16] The headquarter company exemption is provided in section 50D(1)(a)(i)(cc) for “a headquarter company in respect of the granting of financial assistance as defined in section 31 (1) to which section 31 does not apply as a result of the exclusions contained in section 31 (5) (*a*)”.

[17] Section 98(1) of the Taxation Laws Amendment Act 31 of 2013.

[18] Section 1 of the Act defines the Banks Act as the “Banks Act, 1990 (Act 94 of 1990)”

18A of the Banks Act. This certificate authorises an institution which lawfully conducts the business of a bank and which has been established in a foreign country to conduct the business of a bank by means of a branch in South Africa. They are not banks as defined in section 50A as introduced by the Taxation Laws Amendment Act of 2013. This implied that interest paid by an international bank would be subject to WHTI while interest paid by a local bank would be exempt. It goes without saying that such a situation would create an uneven banking environment in terms of which investors would prefer to borrow from local banks than international banks operating in South Africa. This is regardless of the unilateral or multilateral foreign tax relief measures that could be offered for the interest paid to a unilateral tax relief country or the treaty partner. The exemption for local banks and taxation of interest paid by international banks would also create undesirable discrimination against international banks that goes against the spirit of the South African Constitution[19] and the Non-discrimination clause contained in the multitudes of double taxation treaties that South Africa signed with various countries.[20]

This anomaly was unearthed and was rectified by section 64 of the Taxation Laws Amendment Act of 2014[21] by amending the definition of "bank" in section 50A. The amendment changed the definition of bank to read: "'bank' means any bank or branch as defined in section 1 of the Banks Act respectively". Section 1 of the Banks Act defines a branch as "an institution that is not a public company as contemplated in section 11(1), but by means of which a foreign institution conducts the business of a bank in the Republic under an authorization referred to in section 18A.This successfully places international banks and local banks on par as regards interest payments to non-residents.

9.2.1 Bank back-to-back anti-avoidance

Section 50D(2) provides an anti-avoidance measure for instances where a bank can be used as an intermediary or pass through entity for interest paid by an entity that does not qualify for an exemption. This could be achieved where a non-resident entity extends a loan to a resident entity which is not a bank. Under section 50B such interest is subject to the WHTI. There is no exemption for that interest in 50D. The WHTI could be avoided by the non-resident entity lending the capital to a local bank, and the local bank on-lending that amount to a local entity (commonly referred to as a back-to-back loan). On payment of interest, the

[19] See section 9 of the Constitution of the Republic of South Africa Act 108 of 1996.

[20] See the SARS list of treaties on http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx accessed on 06 May 2015 and http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Africa).aspx accessed on 06 May 2015

[21] Taxation Laws Amendment Act 43 of 2014.

WHT does not apply as interest is paid to a resident. When the bank pays the non-resident the interest, such interest would be exempt from WHTI as it is paid by a bank. For income tax purposes, the local entity paying the interest could claim a deduction the full amount of interest (in terms of section 11(a)) and the bank would also deduct the full amount of interest on-paid to the non-resident (in terms of section 11(a)). The bank may be taxed on any commission (albeit minimal) earned in terms of the back-to back loan. In order to curb this form of avoidance, section 50D(2) provides as follows:

> "Interest paid to a foreign person in respect of any amount advanced by the foreign person to a bank is not exempt from the withholding tax on interest if the amount is advanced in the course of any arrangement, transaction, operation or scheme to which the foreign person and any other person are parties and in terms of which the bank advances any amount to that other person on the strength of the amount advanced by the foreign person to the bank."

(a) Coupon Stripping

While this provision could curb the back-to-back loans using banks, it may fall short when it comes to various other forms of transactions designed to avoid the WHTI such as a coupon strip arrangement in terms of which a foreign lender receives funding upfront and the future interest payments on the inter-company loan are paid directly to a local bank.[22]

In terms of this form of coupon stripping a South African tax resident bank purchases the future interest payments from an offshore lender for the discounted present value of such future interest payments. Thus, the lender sells the future interest stream of the inter-company debt to the bank before the interest starts accruing. The offshore lender receives the funds upfront and guarantees future interest payments to the bank. Thus, the bank would have provided funding to the offshore lender equal to the purchase price paid for the future interest payments (being the present value of the interest payments). Future interest payments are made directly to the bank and are exempt from the WHTI. Although these interest payments would be subject to income tax, the bank would have deducted the full present value at the time of the upfront payment to the offshore lender. This transaction achieves the same purpose as factoring a receivable.[23]

The tax implications of this transaction would be that the interest paid by the borrower to the bank is not subject to WHTI because the borrower and the bank are both resident in South Africa. The payment by the bank of the purchase price of the future interest payments is not interest and therefore not subject to the WHTI. The question is then whether

[22] "Coupon stripping is the act of detaching the interest payment coupons from a note or bond and treating the coupons and the body as separate securities" Federal Reserve Bank of New York http://www.newyorkfed.org/aboutthefed/fedpoint/fed42.html accessed on 20 March 2015.

[23] "Accounts receivable factoring is a way for business owners to get working capital to run their business and the peace of mind to know they'll get paid" CIT "Factoring University" http://www.cit.com/factoring-university/accounts-receivable-factoring/index.htm accessed on 20 March 2015.

the common law doctrine of substance over form or the general anti avoidance provisions contained in sections 80A to 80L would prevent this form of avoidance. While it is submitted that the structure of the deal could result in the doctrine of substance over form or the general anti avoidance provisions contained in sections 80A to 80L not being applicable, the determination of whether these anti avoidance measures would prevent this form of avoidance is beyond the scope of this article.

9.3 183 days and permanent establishment exemption

A further exemption is provided for interest that is taxable as normal income in terms of the Act. Section 50D(3) provides as follows:

> "(3) A foreign person is exempt from the withholding tax on interest if—
> (*a*) that foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid; or
> (*b*) the debt claim in respect of which that interest is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act."

In order to obtain relief from WHTI in terms of section 50D(3) section 50E(3)(b) provides that the payer must not withhold any amount of WHTI from interest payment if the recipient made has submitted to the payer a declaration that the recipient in exempt from the WHTI. This additional administrative requirement is due to the fact that the payer does not necessarily have in their custody information relating to the whereabouts or business structures of the recipient to determine if the recipient has spent time in South Africa or operates through a branch to which the interest is attributable or not, as the case may be.

A branch is an extension of its parent company. It does not have separate legal personality apart from its parent company. A South African branch of a foreign company is merely the foreign company carrying on business activities through a permanent establishment in SA. Since a branch of a foreign company does not make the foreign company a resident in SA, in effect interest paid to the branch is technically paid to the non resident parent company of that branch.[24] Such interest would, but for section 50C(3) be subject to the WHTI. However, because the interest paid to the branch is taxable in terms of the normal corporate income tax rules, such interest is exempt from the WHTI. Section 50C(4) provides that: "[a] foreign person is exempt from the withholding tax on interest if… (*b*) the debt claim in respect of which that interest is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act."

[24] Olivier and Honiball International Tax: A South African Perspective (2011) 89 - 91

Similarly interest that is earned by a foreign individual that is taxable in terms of the normal tax system is exempt from the WHTI in terms of section 50D(3)(a). This section provides that foreign person is exempt from the withholding tax on interest if (*a*) that foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid. Such interest is outside the exemption from normal tax that is provided in section 10(1)(h). Section 10(1)(h) exempts interest that is received by or accrues to a person that is not a resident unless the person was physically present in South Africa for a period exceeding 183 days in aggregate during the twelve month period preceding the date on which the interest is received by or accrues to that person. Therefore the interest that is earned by the non-resident individual that has been in South Africa for more than 183 days is subject to normal tax and therefore exempt from WHTI in order to avoid double taxation of the interest.

This exemption effectively eliminates the risk of double taxation of interest as normal income subject to corporate tax and also taxable in terms of the WHTI.

9.4 Tax treaty benefits

Relief from WHTI can be provided by the application of a double taxation agreement between South Africa and the foreign country. Section 50E(3) provides as follows

> (3) The rate referred to in subsection (1) must, for the purposes of that subsection, be reduced if the foreign person to or for the benefit of which the payment contemplated in that subsection is to be made has—
>
> (*a*) by a date determined by the person making the payment; or
>
> (*b*) if the person making the payment did not determine a date as contemplated in paragraph (*a*), by the date of the payment,
>
> submitted to the person making the payment—
>
> (i) a declaration in such form as may be prescribed by the Commissioner that the interest is subject to that reduced rate of tax as a result of the application of an agreement for the avoidance of double taxation; and
>
> (ii) a written undertaking in such form as may be prescribed by the Commissioner to forthwith inform the person making the payment in writing should the circumstances affecting the application of the agreement referred to in subparagraph (i) change.

The provision refers to a reduced tax rate as per a double taxation agreement ("DTA"). In effect the DTA may reduce the rate to as low as 0%. While the Act does not provide for an exemption provided by DTA, the practical effect is the same. However technically the interest is taxable at the rate of 0%. South Africa has a good treaty network with African countries and worldwide countries. In total South Africa has treaties with countries in excess of seventy. Its treaties cover all of its main trading partners and biggest economies in the world. South African treaties provide for a reduction of the WHTI from 15% to 10%, 5% and 0%.

Section 50E(3) implicitly imposes the responsibility to apply treaty relief to the payer of the interest if the following three conditions are met:

(i) The recipient should claim tax treaty relief;

(ii) The tax relief must be claimed by the date determined by the payer or the date of payment if no date is determined by payer. Logically, the date determined by the payer will be prior to the date on which the dividend is paid, or at the latest the date on which the interest is paid as the payer cannot withhold the WHTI once the interest payment is made.

(iii) The recipient must undertake to notify the payer of the circumstance affecting the application of the DTA change. It is not clear what circumstances would change that could affect the application of the DTA once the interest has been paid. However, it is conceivable that the DTA benefits could be affected between the date on which the declaration is made and the date when the interest is actually paid, for example by change of residence of the recipient of the interest. But clearly those circumstances would be scarce. Furthermore, since the provision does not specify whether the recipient should make a declaration for each interest payment made, the circumstances may change between the different interest payment periods.

9.5 Listed debts

Interest paid in respect of ant listed debt is exempt from the WHTI.[25] A listed debt is defined as "any debt that is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule"[26] Paragraph 1 of the Eighth Schedule defines listed debt as an exchange licensed under the Securities Services Act of 2004, which is mainly the Johannesburg Stock Exchange ("JSE"). It also defines a recognised exchange as an exchange in a country other than the Republic which is similar to the JSE which has been recognised by the Minister of Finance for purposes of the Eighth Schedule by notice in the Gazette.

10 *Currency of payments to SARS*

Section 50H provides for instances where the interest payable in terms of a loan agreement is denominated in a currency other than the South African currency, the Rand. In that case, the amount of the WHTI must be translated to the Rand at the spot rate on the date on which

[25] See section 50D(1)(a)(ii).

[26] See definition of "listed debt in section 50A(1).

the amount is withheld. Notably, this is not the spot rate on the date on which the interest is paid. Although the Act does not specifically state the time at which the person paying the interest must withhold, section 50E provides that the person must withhold the WHTI from the payment implying that such withholding would happen at the time of the payment.[27]This therefore implies that the translation to the Rand at spot rate will be done on the date of the payment of the interest.

11 *Refunds*

Section 50G contemplates situations where the recipient of the interest may be either exempt from WHTI or subject to a lower rate in terms of a DTA but fails to submit a declaration to the payer on time. In that case, the payer would withhold the full tax and pay that over to the SARS. Section 50G provides that if such declaration is submitted to the Commissioner for the SARS within a period of three years after the payment of the interest in respect of which the declaration is made, the amount of interest is refundable by the Commissioner. It follows that if the declaration is made before the payer pays the interest over to the SARS the payer should be able to pay the withheld amount or a portion thereof as the case may be to the recipient of the interest.

12 *Conclusion*

The WHTI in South Africa is a welcome alignment of the South African tax system with the international tax practices, could earn South Africa some tax revenue and goes some way to enhance the equal treatment of residents vis-à-vis non-residents. In its nascence, it still does have teething problems that should be cleared in the near future, as some more get discovered. Its main achievement though remains the fact that it eliminates the need for re-characterisation of dividends, royalties and other income as interest, and therefore eases the tax administration of the extended duty of challenging the opportunistic characterisation of amounts as interest.

[27] Section 50E(1) provides as follows: “Subject to subsections (2) and (3), any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest calculated at the rate contemplated in section 50B (1) from that payment.”

Delictual liability of the beneficiary bank in an electronic funds transfer

Desima Beukes[1]: Attorney of the High Court of South Africa

Introduction

This paper investigates issues of delictual liability of a bank towards a non-customer who has suffered financial loss as a result of an electronic funds transfer,[2] more particularly due to fraud perpetrated by a third party.

The construction and terminology used are as follows: the party who suffered the loss is referred to as the defrauded party or victim.[3] Such party is a customer of one bank, referred to as the originator bank. A fraudster unlawfully gains access to the account of the defrauded party at the originator bank through the medium of internet (also called electronic) banking.[4] The fraudster next causes funds from the defrauded party's account to be electronically transferred to an account controlled by him (the fraudster), called the beneficiary account, at another bank, the beneficiary bank. The funds are then withdrawn from the beneficiary account by the fraudster.

There is no contractual relationship between the victim and the beneficiary bank.[5] Therefore, if the victim wishes to claim from the beneficiary bank he must do so by way of an

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[1] I am indebted to Mr Chris Cilliers of the Cape Bar whose research, in a matter where I was his instructing attorney, was helpful in dealing with the complexities of wrongfulness. Any mistakes, however, are mine.

[2] Malan, Pretorius & Du Toit *Malan on Bills of Exchange, Cheques and Promissory Notes* 5ed (2009) para 201 includes electronic funds transfers under the more general classification of "*credit transfers"* and says, at par 202 (footnotes omitted):*"The term '*credit transfer' *is something of a misnomer. It involves neither '*funds' *in the sense of notes and coins nor a physical transfer of funds. The transaction is executed by virtue of a series of mandates resulting in the crediting of the beneficiary's account. What the beneficiary obtains is a personal right against the bank to credit and pay out the amount of the transfer to him. At the same time the originator's account with his bank is debited reducing the amount he is entitled to claim from it. In an economic sense a* 'transfer' *of value has been achieved but no transfer of any kind in the sense in which the term is used in the law of property or obligations. Nor does the transaction amount to a cession of the rights the originator had against his bank to the beneficiary whether or not the beneficiary's account is kept at the same or another bank".*

[3] I use the term "victim" advisedly because as will be demonstrated later the defrauded party's negligence is also at issue.

[4] It is assumed that the reader is familiar with the concept of internet banking. In broad terms, without attempting any legal- or technical definition, it means that a customer may, by arrangement with his bank, access his bank account/s through the internet and effect transactions online (instead of visiting a bank branch or automated teller machine). The only obvious limitation is that the customer cannot draw or deposit cash or paper. In the case of the latter, however, the same result is achieved by electronic payments or receipts.

[5] Malan, Pretorius & Du Toit above n2 para 211: "*It is trite that there is no contractual relationship between the originator of a payment order* [*in casu,* notionally at least, the defrauded party] *and the beneficiary bank. The situation is comparable to the relationship between the owner of a cheque and the collecting bank".*

Aquilian action, i.e. it must be proven that the beneficiary bank wrongfully and culpably (intentionally or negligently) caused harm to the victim.[6]

The wrongfulness aspect of delictual liability in cases of pure economic loss

A consideration of the requirement of wrongfulness is fundamental to the enquiry into possible delictual liability of the beneficiary bank towards a non-customer who has suffered financial loss as a result of electronic banking fraud. This is so because, except for cases relating to negligent misstatements and the extension of liability of a collecting banker to the owner of a stolen or lost cheque, there is no precedent in South African law where a bank has been held liable for pure economic loss suffered by a non-customer, in particular as a result of electronic banking fraud.[7]

Central to the enquiry is the fact that the loss is not in respect of the property or person of the victim but financial loss, commonly referred to as pure economic loss.[8] Where it is contended for the imposition of delictual liability, in respect of pure economic loss, the element of wrongfulness takes on special importance. Whereas negligence that causes physical damage to the person or property of another is prima facie wrongful, negligent causation of pure economic loss is not prima wrongful but depends on the existence of a legal duty.[9] Hence, in cases of pure economic loss (or where the conduct complained of

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[6] See, for instance, Lawack & Pretorius 'The "Sale" of a Bank Account' 2015 (78) *THRHR* 104 105.

[7] *Gilbeys Distillers and Vinters (Pty) Ltd v Absa Bank Limited* 2001 JDR 0411 (C) 1 was concerned, in exception proceedings, with the question whether a beneficiary bank owed the originator of a payment instruction any duty under the following circumstances. The originator had caused, through the originator bank, an instruction to be issued to the beneficiary bank for a payment to be made to an account with the number stipulated by the originator but which belonged to a different entity to that intended by the originator. The court held as follows, at para 81: "*It is clear in our view that Gilbeys is seeking to break new ground by extending Aquilian liability into an area where it has not been recognised previously. In South African law, outside of cases relating to negligent misstatements, claims for pure economic loss in the context of a banker's liability have not been extended beyond the liability of a collecting banker to the true owner of a cheque for economic loss caused by the bankers' negligence in dealing with the cheque*".

[8] "*One the one hand, pure economic loss may comprise patrimonial loss that does not result from damage to property or impairment of personality. On the other hand, pure economic loss may refer to financial loss that does flow from damage to property or impairment of personality, but which does not involve the* plaintiff's *property or person; or if it does, the* defendant *did not cause such damage or injury*" - Neethling & Potgieter *Neethling-Potgieter-Visser Law of Delict* 7ed (2014) at 305 – 306 (footnotes omitted).

[9] This was formulated as follows in *Fourway Haulage SA Pty) Ltd v SA National Roads Agency Ltd* 2009 (2) SA 150 (SCA) para 12: "*Recognition that we are dealing with a claim for pure economic loss brings in its wake a different approach to the element of wrongfulness. This results from the principles which have been formulated by this court so many times in the recent times that I believe they can by now be regarded as trite. These principles proceed from the premise that negligent conduct which manifest itself in the form of a positive act causing physical damage to the property or person of another is prima facie wrongful. By contrast, negligent causation of pure economic loss is not regarded as prima facie wrongful. Its wrongfulness depends on the existence of a legal duty. The imposition of this legal duty is a matter for judicial determination involving criteria of public or legal policy consistent with constitutional norms. In the result, conduct causing pure economic loss will be*

takes the form of an omission), wrongfulness is not presumed and must be shown to exist, i.e. positively established. There is no general right not to be caused pure economic loss and the law is generally reluctant to recognise such claims, particularly novel ones. In this regard the following was said in *Country Cloud Trading CC v MEC, Department of Infrastructure Development:*[10]

> "*So our law is generally reluctant to recognise pure economic loss claims, especially where it would constitute an extension of the law of delict. Wrongfulness must be positively established. It has thusfar been established in limited categories of cases, like intentional interference in contractual relations or negligent misstatements, where the plaintiff can show a right or legally recognised interest that the defendant infringed.*"[11]

The limited categories of cases, as referred to above in *Country Cloud,* has also been described as "*categories fixed by the law*"[12] *.* The matter of *Indac Electronics (Pty) Ltd v Volkskas Bank Ltd,*[13] in which it was held that a collecting banker owes a legal duty to the owner of a cheque, is cited as an example (in addition to those referred to in *Country Cloud*).

At the heart of the general reluctance of our law to recognise pure economic loss claims, is the "*first principle of the law of delict",*[14] namely that harm rests where it falls, or, put differently, that each person must bear the loss that he suffers.[15] When delictual liability is contended for, where none existed before, the question is whether there are any considerations of public or legal policy which require an extension of delictual liability.[16] The

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only be regarded as wrongful and therefore actionable if public or legal policy considerations require that such conduct, if negligent, should attract legal liability for the resulting damages (see eg Minister of Safety and Security v Van Duivenboden *2002 (6) 431 (SCA) ([2002] 3 All SA 741) paras 12 and 22;* Gouda Boerdery BK v Transnet *2005 (5) SA 490 (SCA) ([2004] 4 All SA 500) para 12;* Telematrix *(supra) paras 13 – 14;* Trustees, Two Oceans Aquarium Trust (*supra) paras 10 – 12)*".

[10] 2015 (1) SA 1 (CC).

[11] Para 23 (footnotes omitted).

[12] *Telematrix (Pty) Ltd t/a Matrix Vehicle Tracking v Advertising Standards Authority SA* 2006 (1) SA 416 (SCA) para 15 (footnotes omitted).

[13] 1992 (1) SA 783 (A).

[14] *Telematrix* above n12 para 12.

[15] Ibid para 12; Neethling & Potgieter above n8 at 3.

[16] "*When we say that a particular omission or conduct causing pure economic loss is 'wrongful', we mean that public or legal policy considerations require that such conduct, if negligent, is actionable; that legal liability for the resulting damages should follow. Conversely, when we say that negligent conduct causing pure economic loss or consisting of an omission is not wrongful, we intend to convey that public or legal policy considerations determine that there should be no liability; that the potential defendant should not be subjected to a claim for damages, his or her negligence notwithstanding. In such an event, the question of fault does not even arise. The defendant enjoys immunity against such conduct, whether negligent or not. … When a court is requested in the present context to accept the existence of a 'legal duty', in the absence of any precedent, it is in reality asked to extend delictual liability to a situation where none existed before. The crucial question in that event is whether there are any considerations of public or legal policy which require that extension" - Telematrix* above n12 para 16.

yardstick is the criterion of reasonableness or *boni mores.*[17] This requires a weighing up of the interests of all the parties, taking into account the public interest[18] and does not depend on the idiosyncratic views of an individual or judge.[19]

A consideration that is taken into account by our courts relates to the spectre of indeterminate liability. Liability will more readily be imposed "*for a single loss of a single identifiable plaintiff but once and which is unlikely to bring in its train a multiplicity of actions*"[20] If claims for pure economic loss are too freely recognised, there is a risk of "'*liability for an indeterminate amount for an indeterminate time to an indeterminate class'.*[21] Thus, in *Country Cloud* the following was said:

> "*Pure economic losses, unlike losses resulting from physical harm to person or property - 'are not subject to the law of physics and spread widely and unpredictably, for example, where people react to incorrect information in a news report, or where the malfunction of an electricity network causes shut-downs, expenses and loss of profits to businesses that depend on electricity*'"[22]

But even if the risk of indeterminate liability is absent, this will not without more give rise to the imposition of liability. What is also taken into account is whether or not the plaintiff was vulnerable to risk, or conversely, took or could reasonably have taken steps to protect itself from or avoid the loss suffered.[23]

Another factor that is sometimes taken into consideration is whether the imposition of delictual liability would impose an additional burden on the defendant, which would be unwarranted or which would constitute an unjustified limitation of the defendant's activities. The converse of this consideration is that the imposition of liability would not unreasonably interfere with the defendant's commercial activities, since the defendant is already under a duty to take reasonable care in respect of third parties.[24]

In conclusion: because there is no general duty to prevent pure economic loss, each case must be determined on its own facts. Wrongfulness must be established vis-à-vis the particular plaintiff, and not in some generalised sense.[25] As it was put in *Telematrix:*[26]

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[17] Neethling & Potgieter above n8 at 308 and cases cited there.

[18] Ibid at 308 and cases cited there.

[19] *Fourway Haulage* above n9 para 16.

[20] Ibid para 24.

[21] *Fourway Haulage* above n9 para 25; *Country Cloud* above n10 para 24.

[22] Ibid para 24 quoting from Loubser & Midgley (eds) *The Law of Delict in South Africa* 2ed (2012) 228.

[23] Ibid para 51.

[24] *Fourway Haulage* above n9 para 26.

[25] *Country Cloud* above n10 para 19.

[26] *Telematrix* above n12.

whereas, "*since Indac,*[27] *it is well-nigh impossible to argue that a collecting bank has no such duty* [towards the owner of a cheque] *… all that may remain is to consider whether vis-à-vis the particular plaintiff the duty existed".*[28] Ultimately, it is about the reasonableness or otherwise of imposing liability.[29]

If liability is to be ascribed to a beneficiary bank for loss suffered by a non-customer as a result of electronic banking fraud it will require an extension of delictual liability as described, among others, in *Fourway Haulage.*[30] Two possible grounds, on which a beneficiary bank might be held liable in principle, have been mooted. Each of these will be examined separately below. Before doing so, however, it is necessary to say something about the security features of internet banking and the manner in which electronic banking fraud is perpetrated.

<u>The security features of internet banking</u> [31]

To access his internet banking account a customer must enter his security details, typically consisting of a profile- or account number, personal identification number (PIN) and a password. The PIN and password are chosen by the customer and are not known to the bank. The customer is obliged to keep the PIN and password confidential.[32] However, these are not the only security details which allow access to the user's internet banking profile; there is a second level of security measures imposed by banks. These security measures differ in content and execution from bank to bank but their effect are generally the same, namely that the user is supplied with another, random password or code which he must enter on the banking website before he gains access to his internet banking account. Such code or password is sent by short message service (sms) to the mobile phone of the customer or is broadcast by electronic means to a token (which token is issued to the customer at the inception of the internet banking functionality extended to the customer).

A third level of security measures operates in respect of certain sensitive transactions, for example to create new beneficiaries[33] or to change the maximum monetary

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[27] *Indac* above n9.

[28] *Telematrix* above n12 para 15.

[29] *Country Cloud* above n10 para 21.

[30] See n16.

[31] Most readers will be familiar with the features explained here. However, see *Roestoff v Cliffe Dekker Hofmeyr Inc* 2013 (1) SA 12 (GNP) paras 7 and 8 and *Nashua Mobile (Pty) Ltd v GC Pale CC t/a Invasive Plant Solutions (Pty) Ltd* 2012 (1) SA 615 (GSJ) para 10 for useful explanations of the security measures employed by the banks in question (ABSA and Nedbank respectively).

[32] This obligation, and various other obligations of the user, will be dealt with below.

[33] Internet banking typically allows for a user to "link" a party (the beneficiary) to whom the user wishes to make payment/s, by entering the banking details (name of the bank and account number) of

limits of transactions that may be effected by the user by way of internet banking. In those cases, the user is again supplied with a new random code or password which must be entered by the customer; or the user receives a message on his mobile phone requiring him to confirm his electronic instruction by return message. Only when the password or code has been entered, or the instruction has been confirmed, is the user allowed to proceed with the sensitive transaction.[34]

In addition, banks offer a service whereby a customer is notified by sms or email on each occasion that a transaction is effected on his account.[35] This means, in theory at least, that if transactions occur on a customer's account that are not initiated by the customer, he can respond swiftly and notify the bank that his account must be suspended.

<u>How fraudsters gain access to victims' accounts</u>

How then, in the face of such elaborate security measures, does internet banking fraud occur? The evident answer is that the fraudster cannot access the account of the victim unless he (the fraudster) is in possession of the security details of the account of the victim. Typically, the fraudster obtains these security details by means of a scam.[36] The most prevalent [37] of these scams is known as phishing,[38] which means that:

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the beneficiary on the user's internet banking profile. This enables the user to make electronic funds transfers to the beneficiary through the bank clearing system.

[34] See, for example, http://www.nedbank.co.za/website/content/approveit/index.asp, accessed on 4 May 2015, for an explanation of Nedbank's security system known as "Approve-It".

[35] For example, according to its website (http://www.absa.co.za/Absacoza/Individual/Ways-to-Bank/Anytime%2C-Anywhere/NotifyMe, accessed on 4 May 2015) ABSA offers a service known as "NotifyMe" which will alert the customer "*to transactions that take place on [his] account with an immediate SMS or email", if the customer so chooses.* FNB (https://www.fnb.co.za/ways-to-bank/online-banking.html, accessed on 4 May 2015), Standard Bank (https://www9.encrypt.standardbank.co.za/ibsa/InternetBanking, accessed on 4 May 2015) and Capitec (https://www.capitecbank.co.za/global-one/ways-to-transact/information-services, accessed on 5 May 2015) also offer this service. The Code of Banking Practice (http://www.banking.org.za/docs/default-source/default-document-library/code-of-banking-practice-2012.pdf?sfvrsn=10, accessed on 5 May 2015) says in this regard, at clause 7.7.7: "*You* [the user] *may be able to subscribe to receive transaction notifications via sms that may be used to alert you of unauthorized activity on your account."*

[36] It may be that, on occasion, the victim deliberately divulged his security details to the fraudster, or that an account is hacked. In the former case the consequences will not be much different to those discussed in this paper. The latter case, of hacking, invites altogether different considerations which are not within the scope of this paper. Also, instances where an employee who is entrusted with the financial affairs of his employer commits electronic banking fraud on his employer are not considered in this paper – in this regard see, for instance, Powell 'Critical Measures to Protect Against Rocketing EFT Fraud Risk' (2009) *Without Prejudice* December 48.

[37] Cassim 'Addressing the spectre of phishing: are adequate measures in place to protect victims of phishing?' 2014 47(3) *Comparative and International Law Journal of South Africa* 401 403.

[38] There are other scams, and variations on the theme of phishing. Nedbank, on the landing page of its internet banking functionality (https://netbank.nedsecure.co.za, accessed on 5 May 2015), gives an

> "…*a user is conned into revealing the access details of his banking account and access password details through the use of sophisticated web pages or emails that resemble or mimic a regular login page of a bank or financial institution website and which usually contain 'urgent attention' or similar content that entices and tricks the recipient into divulging their bank user name as well as their mobile phone number as provided to the bank".*[39]

When the victim is diverted to the fake website set up by the fraudster, he reveals his security details to the fraudster which will enable the fraudster, ultimately, to access the account of the victim and perform the fraudulent transactions. However, being in possession of the security details of the account only is not enough. The fraudster must also intercept the sms sent by the bank to the mobile phone of the victim (in the second- and third level of security measures employed by banks, as explained above). This is achieved by so-called SIM-card swopping at the mobile phone service provider.[40] The result of SIM-card swopping is that the sms containing the further password or code is diverted to a mobile phone under the control of the fraudster, who then uses the password or code to access the account of the victim and to create a new beneficiary account on the internet banking profile of the victim. That new beneficiary account is one which is under the control of the fraudster at the beneficiary bank.

<u>Beneficiary accounts at the beneficiary bank</u>

Leaving aside (for the moment) any common law duty on them,[41] banks must give effect to the provisions of the Financial Intelligence Centre Act 38 of 2001 ("FICA") when opening new, and maintaining, accounts for customers. An "accountable institution",[42] like a bank, may not enter into a business relationship or conclude a single transaction with a customer unless certain prescribed steps to establish and verify the identity of the customer have been

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insightful explanation of the various ways in which internet banking fraud may occur. This paper is confined to phishing.

[39] Perlman 'Legal and Regulatory Aspects of Mobile Financial Services' (2012) *unpublished LLD dissertation UNISA* 213. See also *Nashua Mobile* above n31 para 20.

[40] Van der Bijl 'SIM-card Swapping, Mobile Phone Banking Fraud and RICA 70 of 2002' (2009) 21 SA *Merc LJ* 159 159-160 (footnotes omitted) explains SIM-card swapping as follows: "*'Swapping' occurs where the fraudster gains access to sensitive information that is sent either via sms (short message service) to a cellular phone, or to a banking client's email address. The fraudster then poses as the client and has a new card illegally assigned to the same cellular number as the original SIM card, via a SIM card' swap'. The one SIM card is therefore 'swapped' for another SIM card, and the cell phone service provider will then transfer the SIM-card identity of that particular client to that of the fraudster. The previous SIM-card is then cancelled. Consequently, the legitimate owner of the original SIM-card no longer receives any notification SMS's and is therefore oblivious of the fraud being perpetrated against him. As the fraudster is allocated the cellular phone number and the replacement card, the SMS authorisation facility provided by banks to their client is intercepted, allowing the fraudsters to receive security messages, SMS authorisation reference numbers and the one-time password. The fraudster can then transfer money, create beneficiaries and make payments at will".*

[41] This is discussed later.

[42] Defined in section 1 of FICA.

taken.[43] It must formulate and implement internal rules concerning the establishment and verification of the identity of clients[44] and must take reasonable steps, in the ongoing relationship with the customer, to maintain the correctness of particulars which are susceptible to change.[45]

Given the requirements of FICA, it will be difficult for a fraudster to open an account with the beneficiary bank (which account will ultimately be used to perpetrate the fraud on the victim) under an assumed identity[46] and, unless the fraudster is arrogant and confident that the long arm of the law will not reach him eventually, it stands to reason that he will not open the account with his own identity. Thus, to circumvent the effects of FICA, fraudsters persuade third parties, in exchange for reward, to either open new accounts or give access to their existing accounts to fraudsters.[47] In either event the (notional) account holder will (a) disclose his security details, if he has subscribed to internet banking, to the fraudster and/or (b) hand over his bank card, together with the security information (typically the PIN) relating to the card, to the fraudster.

Summing up

It is against this background, of (a) the general reluctance of our courts to extend delictual liability where none existed before and the general policy considerations pertaining thereto, (b) the security features of electronic banking employed by banks and (c) the nefarious methods employed by fraudsters to, on the hand, gain access to a victim's account at the originator bank and, on the other hand, obtain control of an account at the beneficiary bank, that the potential liability of the beneficiary bank for electronic funds transfer fraud – in particular phishing fraud - must be considered. For convenience the term "phishing" will hereafter be used.

[43] Section 21 of FICA. Regulations (Money Laundering and Terrorist Financing Control Regulations, GN R 1595 GG 24176 of 20 December 2002) and guidance notes (Guidance for Banks on Customer Identification and Verification, GN 715 GG 27803 of 18 July 2005 [Guidance Note 3] and the Financial Intelligence Centre Guidance Note 3A: Guidance for Accountable Institutions on Client Identification and Verification and Related Matters) have been published pursuant to FICA, to regulate and assist with the verification process. It should also be mentioned that a draft of a Financial Intelligence Centre Amendment Bill, which proposes wide-sweeping amendments to FICA, was recently published for public comment. See GN 342 GG 38278 of 22 April 2015.

[44] Section 42(1)(a).

[45] Regulation 19 – see n43.

[46] Conceivably, however, documents required by a bank to open an account (so-called FICA documents) could be forged and, if the forgery is convincing enough, go undetected by the bank in question.

[47] Lawack & Pretorius above n6 at 104.

Grounds on which it has been suggested that the beneficiary bank may be held liable: opening of new accounts by the beneficiary bank

One of the grounds on which it has been suggested that the beneficiary bank might possibly be held liable for loss suffered by the victim as a result of phishing relates to the opening of new accounts, on the basis that the position of the beneficiary bank is analogous to that of the collecting banker in the collection of cheques. Lawack and Pretorius say, under the heading "*Analogy with funds transfers and delictual liability of collecting bank towards owner of lost or stolen cheque?*[48]

> "*It is submitted that that a collecting bank*[49] *has a general legal duty to prevent harm (pure economic loss) as was set out in Energy Measurements. If the collecting bank that opened a new bank account did not follow the requirements of the common law and the Financial Centre Act 38 of 2001 it should, in principle, be visited with liability towards the former "owner" of the stolen funds. (It should be remembered that once money is paid into a bank account the bank becomes the owner of the money (*Trustees, Estate Whitehead v Dumas *2013 3 SA 331 (SCA).)*"[50]

In what follows it is examined whether the analogy posed by the authors (over which they place a question mark) necessarily holds true.[51]

The cheque cases

The point of departure in the enquiry is three pertinent cases, which will be referred to as "the cheque cases" for sake of convenience, in which the delictual liability of collecting bankers of cheques was considered and extended. These cases are dealt with at some length, for two reasons: on the one hand, to illustrate the ultimate submission that these cases are not authority for the general proposition that there is a legal duty on a beneficiary bank to prevent harm in the context of phishing; on the other hand, because, nevertheless, the policy considerations (or at least some of them) which, in those cases, operated in favour of the extension of delictual liability on the part of collecting bankers are relevant to the enquiry into a similar extension in respect of beneficiary banks .

The first pertinent case is *Indac Electronics (Pty) Ltd v Volkskas Bank Limited.*[52] The court considered the following factors in favour of a finding that, *prima facie,* a collecting banker owes a legal duty to the owner of a lost or stolen cheque:[53]

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[48] Ibid at 108.

[49] It is clear from the context that the authors use the term "collecting bank" in the same sense as a beneficiary bank in an electronic funds transfer.

[50] Lawack & Pretorius above n6 110.

[51] It is apparent from the "*in principle"* qualification that the focus of the authors was not on the *sui generis* nature of phishing; in effect they implied that, in the final analysis, the imposition of liability would depend on a balancing and evaluation of all the relevant policy considerations.

[52] 1992 (1) SA 783 (A). This was a landmark decision in the sense that for 60 years, since the decision in *Yorkshire Insurance Co Ltd v Standard Bank* 1928 WLD 223, a collecting banker who

- the objection of indeterminate liability does not arise because the extent of the potential loss is finite (the face value of the cheque), the claimant is predictable (the drawer or payee of the cheque) and each potential claim will arise separately;
- because there is an ever-present risk that payment of a cheque can be obtained by an unlawful possessor with relative ease, there is a need for protection to the owner of the cheque particularly because such owner relies on the colleting banker to look at the named payee on the cheque;
- the collecting banker undertakes professional services and possesses special skill and competence and can (or should) appreciate the significance of instructions on a cheque; he should be able to reduce or avoid loss to the true owner by exercising reasonable care in the collection of cheques;
- the collecting banker is the only person who is in a position to know whether or not a cheque is being collected on behalf of a person who is entitled to receive payment;
- the drawer or true owner of a cheque is unable to take any steps to protect himself from the loss he will suffer if the collecting banker negligently collects payment on behalf of a person who is not entitled thereto;
- on the other hand, if a negligent collecting banker is held liable for damages to the true owner, he would have a claim for reimbursement against the customer who deposited the cheque for collection; if the customer is unable to pay, it would be more appropriate to visit liability on the banker who chose to accept the customer's business than on the true owner;
- it may well be that the collecting banker could protect himself against loss by relatively inexpensive insurance cover.

However, because the court was seized with exception proceedings, a final evaluation and balancing of the relevant policy considerations could not be undertaken; the *prima facie* indication of liability could be rebutted by evidence which the defendant might lead at a trial, tested and evaluated against any countervailing evidence presented by the plaintiff.[54]

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negligently collected payment of a cheque on behalf of a customer who had no title thereto was not held liable under the *lex Aquilia* for pure economic loss sustained by the owner of the cheque. The decision in *Administrateur, Natal v Trust Bank van Afrika,* in which delictual liability for pure economic loss caused negligently was recognised, paved the way for imposition of liability on a collecting banker.

[53] Ibid at 798C – 800A.

[54] Ibid at 801B – C.

Indac did not proceed to trial, so in *KwaMashu Bakery Ltd v Standard Bank of South Africa Ltd.*[55] the issue was considered for the first time[56] in trial proceedings. The defendant bank had taken the matter to trial with the intention of making it a test case.[57]

KwaMashu was concerned with two cheques which had been marked "non-transferable" and made payable to "KwaMashu Bakery Limited only". The fraudsters had stolen the cheques and deposited them into an account at the defendant (collecting) bank which they had opened in the name of "KwaMashu Bakery Limited Soccer Club". It was contended by the plaintiff that the defendant had been negligent in collecting the cheques for the credit of that account. The defendant bank led evidence about banking practice and – procedures, not only at the defendant bank but generally in the cheque clearing system. In particular, the defendant's witness testified about the costs that would be incurred by banks if they were to scrutinise cheques to detect ones marked "non-transferable", in order to ensure that they were collected for the credit of accounts matching exactly the description of payees on the cheques.

The court made short thrift of the defendant's arguments. It said that:[58]

- the banking public is aware of the value of a non-transferable cheque and is in need of the protection that it offers;
- banks have, even prior to the decision in *Indac,* developed a system of checking that the proceeds of a non-transferable cheque;
- the evidence showed that the banks adopted a resolution[59] as follows: "

> *Banks will deal with cheques, the transfer of which is prohibited by wording on the face thereof (such as "not-transferable") in only one manner, namely by accepting them for the credit of an account bearing the identical name to that of the payee named on the cheque";*

- although there are costs involved with the existence of a duty they are not disproportionate to the harm which is guarded against:
- telephonic enquiries to the drawee bank and in turn to the drawer (which according to the evidence was impractical) can be avoided by the designated officer having access to the full name of the depositor on the bank's computers, and not only (as the evidence showed the case was) a truncated name of the account holder;

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[55] 1995 (1) SA 377 (D).

[56] A prior matter, *Volkskas Bank Beperk v Bonitas Medical Aid Fund* 1993 (3) SA 779 (A), did go to trail but the bank did not lead evidence, as postulated in *Indac,* in rebuttal of the *prima facie* existence of a legal duty on the part of the collecting bank. The trial in that matter was concluded before *Indac* was reported, which explains why such evidence was not led (see *KwaMashu* above n55 at 379I – 380A).

[57] *KwaMashu* above n55 at 380B.

[58] Ibid at 393A-394G.

[59] Under the auspices of the Banking Council of South Africa (as it was then known).

- the argument which is unanswerable is that, if there is no duty of care owed by a collecting banker, the banks need not bother to even look at cheques which are deposited for collection to ascertain whether the depositor is the named payee;
- *"Moreover, it offends against one's sense of fairness and reasonableness for bankers who by statute are the only institutions entitled to take and collect negotiable instruments and are regarded by society as professional persons and institutions competent in dealing in money matters to, on the one hand, procure custom by inviting the public to bank with them and representing that they will collect cheques on behalf of their customers and, on the other hand, saying*

> *'there is a risk that when we collect a cheque it may not be for the true owner but although we are aware of this risk it is going to cost us too much to guard against it and therefore we are going to take no steps to protect the true owner'.* [60]

The court thus found that the defendant bank owed the plaintiff a duty to display reasonable care in the collecting of the proceeds of the cheques in question so as to ensure that they were credited to the account of the payee and not someone else who was not entitled to such proceeds.[61] This disposed of the wrongfulness element of delictual liability.

The court then turned to the standard of care required of the collecting bank, i.e. the issue of fault. It held as follows:

> *"The question is what reasonable, practical and affordable measures would the reasonable, prudent collecting banker have taken in order to have prevented the harm which resulted to the plaintiff (Marfani & Co Ltd v Midland Bank Ltd [1968] 2 All ER 573 (CA); Regal v African Superslate (Pty) Ltd 1963 (1) SA 102 (A) at 111H and 117A).*
>
> *In order to succeed in obtaining the proceeds of his theft of a cheque the thief has to open a bank account with the collecting banker. This he normally does after theft of the cheque, the account then being opened in a name as close as possible to the named payee. As a first step towards protection of the true owner, I think it could be expected of a reasonable banker to not only satisfy himself of the identity of a new client but also gather sufficient information regarding such client to enable him to establish whether the person is the person or entity which he, she or it purports to be. Checks could be made on places of employment, address given, whereabouts of next of kin, etc before accepting the person as a customer. This could in no way impact on the banking system or involve an unreasonable amount of time or cost."* [62]

A spate of cases against collecting bankers followed *KwaMashu* but only the two most important, in the context of this discussion, are considered namely *Energy Measurements (Pty) Ltd v First National Bank of SA Ltd* [63] and *Columbus Joint Venture v ABSA Bank Ltd.*[64] *Energy Measurements* concerned a fraudster who deposited two stolen cheques payable to

60 *KwaMashu* above n55 at 394E – G.

61 The court answered questions as had been formulated by the parties for decision; this finding of the court followed the formulation of the question under consideration.

62 *KwaMashu* above n55 at 395H – 396C.

63 2001 (3) SA 132 (W).

64 2002 (1) 90 (SCA).

"Energy Measurements" to an account that he opened in the name of "Tradefast 8 (Pty) Ltd trading as Energy Measurements". There were certain discrepancies in the documentation submitted to the bank by the fraudster when he opened the account which, so the court found, should have put the bank on its alert when the account was opened. The court then went one step further than *KwaMashu* and held that the legal duty (i.e. in the context of wrongfulness) on the collecting banker to prevent loss extended to the opening of accounts:

> *"There are valid and compelling considerations for the imposition of a duty of care on a bank when opening an account:*
>
> *114.1 The risk that an account may be opened for fraudulent purposes to serve as a conduit for stolen cheques is a clear and recognised one. Once an account is opened, the channelling of a stolen cheque through such an account becomes a relatively easy exercise.*
> *114.2 The opening of an account is a necessary prerequisite to obtain payment in respect of stolen cheques which are drawn in favour of a specific drawee and marked as non-transferable. In the absence of an account which can serve as a conduit for such cheques it would be extremely difficult to obtain the proceeds of the theft thereof.*
> *114.3 A bank is free to either accept or decline the custom of a client and in opening an account and making the bank's facilities available to a customer, it creates a potential risk to the public and in particular to owners of cheques if that account is thereafter misused for fraudulent purposes.*
> *114.4 In contradistinction to the pressures of time under which collecting banks have to operate in processing high volumes of cheques, a bank is not operating under such time constraints or pressure in deciding whether to open a new account or not.*
> *114.5 No significant additional costs or time would be spent if care is taken in considering whether an account should be opened or not, and it would clearly not impact on the banking system as such.*
> *114.6 The decision whether an account should be opened provides the best opportunity to prevent fraud from being perpetrated".* [65]

Columbus further refined the duty on banks when opening accounts, by holding that a bank may differentiate between the opening of an account for an existing customer and a new customer because, in the case of an existing customer:

> "*The pre-eminent consequence is heightened accountability, which substantially diminishes the possibility of the account being used with impunity for fraud. There exists then a significant disincentive to fraudulent use of the account, which is absent in the case of a new customer whose identity and location and other details have not been verified. It is this that bears upon the bank's duty in opening an account*".[66]

<u>*The distinction between collection of cheques and electronic funds transfers*</u>

The pivotal factual consideration in the cheque cases was that the fraud could not have been perpetrated unless the fraudsters opened accounts under names which (more or less) matched the payees on the cheques in question. In this regard it should be borne in mind that cheques are deposited physically with the bank, either over the counter in a branch or at

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[65] *Energy Measurements* above n63 para 114.

[66] *Columbus* above n64 para 9.

an automated teller machine, and positive conduct by the bank employees is required to ultimately credit the proceeds of the cheque to an account. In order to deposit a stolen cheque, a fraudster must therefore assume a false identity or misrepresent his entitlement to the cheque or alter the cheque, or combine all of these stratagems. It is reasonable that in those circumstances, precautionary measures on the part of banks when opening new accounts (as described in the cheque cases), could prevent the fraud from being committed.

By contrast, a beneficiary bank has no means of establishing whether the holder of the beneficiary account is entitled to a payment made to that account by electronic funds transfer. There is no physical payment instrument. The originator (or the fraudster, then) merely captures the name of the beneficiary bank and the account number of the beneficiary at that bank on the internet banking profile of the account holder at the originator bank.[67] The beneficiary bank (and for that matter, also the originator bank) has no knowledge or control over whether those details match with the intended beneficiary. Thus, the fundamental factual consideration in the cheque cases is absent in the case of phishing.

In the result phishing can be perpetrated with equal success whether the fraudster is who he claims to be or not. The success or otherwise of the fraud does not depend on the misrepresentation, by the holder of the beneficiary account, of his identity but rather on account- and account information abuse. As was pointed out above, it is unlikely that fraudsters would open beneficiary accounts in their own names. Rather, they gain control of accounts which had been opened by someone else. These accounts could have been opened for legitimate purposes, or perhaps in collusion with the fraudsters, but the point is that the identity of the account holder is strictly speaking irrelevant. Successful phishing fraud is therefore possible – and indeed occurs – by using beneficiary accounts that have been opened in accordance with both the principles enunciated in the cheque cases and FICA.

It can therefore not be said, as in *Energy Measurements,* that "*the decision whether an account should be opened or not provides the best opportunity to prevent fraud from being perpetrated".*[68] Even a properly opened and verified account can easily be used for phishing if the relevant account information can be obtained by the fraudsters.

For similar reasons, the conclusion in *Columbus* that proper verification of the identity and other details of a prospective client result in "*heightened accountability, which substantially diminishes the possibility of the account being used with impunity for fraud*"[69] cannot be made to apply in the context of phishing fraud.

[67] See, for instance, Powell 'Critical Measures to Protect Against Rocketing EFT Fraud Risk' (2009) *Without Prejudice* December 48 48.

[68] *Energy Measurements* above n63 para 114.6.

[69] *Columbus* above n64 para 9.

Simply put, phishing could occur even in the face of the most rigorous account opening procedures. In saying so it is not suggested, of course, that a beneficiary bank who opens an account in disregard of the requirements of FICA and the principles that were established in the cheque cases is not negligent. That would all depend on the facts of the particular case.[70] The issue under consideration here is a different one. It is about the question whether such bank's conduct is wrongful, so that the bank – if it is found to have been negligent - may be held liable in delict for pure economic loss suffered by the victim.

It is therefore submitted that the principles established in the cheque cases do not apply without more to the opening of new accounts by beneficiary banks in the context of electronics funds transfers. It seems that there is judicial recognition for this proposition. In *Commissioner, South African Revenue Service v ABSA Bank Limited*[71] it was contended that the defendant had been negligent in opening and maintaining an account in circumstances which did not involve the collection of a cheque (albeit that phishing was also not at issue). The court held that "[*a*]*s appears from the* Indac Electronics *case, the duty owed to a true owner of a cheque has a particular history and particular considerations are of application*"[72] and "[*i*]*t is for this reason that the authorities relied on by the plaintiffs to establish the legal duty relating to the opening of the account in question* in casu *do not provide a complete answer in considering whether such a duty exists".*[73]

Hence, the imposition of liability on beneficiary banks would require an extension of delictual liability which, as was explained at the outset, requires an enquiry into the element of wrongfulness and, hence, policy considerations. This is dealt with below.

FICA

FICA can be disposed of with some brief remarks. The breach of a statutory duty, such as the duties imposed by FICA, is not necessarily wrongful. Such a breach may, however, be one of the factors to be considered in deciding whether the conduct complained of was wrongful. A plaintiff that relies on the breach of a statutory duty for the purposes of a claim in delict must prove a direct interest in the matter, not one that extends to the public at large.[74]

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70 For that reason, the issue of negligence is not considered in this paper. See, however, for instance *Columbus* above n64 and *Powell v ABSA Bank Ltd t/a* 1998 (2) SA 807 (A) where, in the context of stolen cheques, the bank was held to not have been negligent.

71 2003 (2) SA 96 (W).

72 Ibid para 42.

73 Ibid para 43.

74 See, for instance, *Patz v Green & Co* 1907 TS 427 at 433 - 4; *Olitzki Property Holdings v State Tender Board* 2001 (3) SA 1247 (SCA) para [12]; *Steenkamp NO v The Provincial Tender Board of*

Policy considerations relevant to the extension of delictual liability to beneficiary banks in respect of the opening of new accounts

Because the policy considerations in favour of the extension of delictual liability are cheque-specific, most of them are not relevant in the context of the beneficiary bank that opens an account which is used for phishing fraud. In *Commissioner, South African Revenue Service*[75] the following was said:

> *"There are many considerations relating to the true owner of a cheque which are inapplicable to the present situation such, as the ever-present risk in relation to a cheque that payment can be obtained by an unlawful possessor with relative ease, the reliance by the true owner on the collecting banker to check the named payee before collecting, the fact that the crossing on the cheque would be of little consequence if the bank could ignore it, the consideration that the collecting banker is the only person who is in a position to know whether or not a cheque is being collected on behalf of a person entitled to receive payment and the fact that the true owner is unable to take any steps to protect himself from the loss if the true collecting banker negligently collects payment on behalf of a person who is not entitled thereto*." [76]

Nevertheless there is support for the proposition that some the considerations applicable to the recognition of a duty on the part of a collecting banker should apply to a beneficiary bank. This is what Lawack and Pretorius say, in effect, by way of their "*in principle"* formulation where they contend for a legal duty on the part of the beneficiary bank who has fallen short in the required standards for the opening of a new account.[77] Malan, Pretorius & Du Toit[78] say, in a discussion about the beneficiary bank (albeit not on all fours with the present subject) that "*some of the considerations and principles applicable to the recognition of a duty of care on the part of the collecting bank towards to the owner of a lost or stolen cheque should also apply to the matter under discussion*".[79] They go on to say:

> "*Here we can think of the consideration that the loss is not indeterminate, the beneficiary bank undertakes professional services, the responsibility of the bank to ensure that payment system is a relatively safe system, etc"* [80]

Although some policy considerations were advanced in *Commissioner, South African Revenue Service*[81] in support of a prima facie existence of a legal duty on a bank (other than a collecting bank) in opening, managing and maintaining accounts, they are not really helpful

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the Eastern Cape 2007 (3) SA 121 (CC) paras [38] ff; *Premier Western Cape v Fair Cape Property Developers (Pty) Ltd* 2003 (6) SA 13 (SCA) paras [33] ff; LAWSA Volume 8(1) para 74.

75 *Commissioner, South African Revenue Service* above n71.

76 Ibid n70 at 118 n30.

77 Lawack & Pretorius above n6 at 110.

78 Malan, Pretorius & Du Toit above n2.

79 Ibid para 201.

80 Ibid para 201 n45.

81 *Commissioner, South African Revenue Service* above n71.

in the present context because they seem to focus on the ongoing management and maintenance of accounts, rather than their opening.[82] Perhaps this is what the judicial future holds: a shift, away from the emphasis on the opening of accounts, to the managing and maintaining of accounts. This aspect is dealt with below.

Causation

But even if wrongfulness on the part of the (negligent) beneficiary bank is established, the question of causation remains.

Causation involves two enquiries. The first is the enquiry into factual causation, which is conducted by applying the so-called "but-for test" to determine whether the postulated cause can be identified as a *sine qua non* for the loss in question. If, absent the wrongful conduct, the loss would have occurred in any event then no legal liability arises. If, however, it is demonstrated that the wrongful fact was a *causa sine qua non* of the loss liability does not arise without more. The second enquiry must then be made, namely whether the wrongful act is linked sufficiently closely or directly to the loss or, conversely, whether the loss is too remote.[83] This issue is sometimes referred to as remoteness of damage and sometimes as legal causation.[84]

Legal causation, like wrongfulness, is determined by considerations of policy. It has been described as a "longstop" where "*right-minded people, including judges, will regard the imposition of liability in a particular case as untenable, despite the presence of all other elements of delictual liability".*[85] It is a "*mechanism of control in pure economic loss that can work in tandem with wrongfulness*".[86] Because wrongfulness and legal causation are both determined by policy considerations some overlapping is inevitable.[87] Nevertheless:

> "*wrongfulness and remoteness are not the same in all respects. They involve two different elements of the law of delict, each its own characteristics and content. Even when negligent conduct resulting from pure economic loss is for reasons of policy found to be wrongful, the loss may there, for other reasons of policy, by found to be too remote and therefore not recoverable… Determination requires applications of yardsticks such as foreseeability and direct consequences which do not play a role in establishing wrongfulness…. What has also become generally accepted is that these yardsticks should not be applied dogmatically but, rather, in a flexible manner*". [88]

[82] These considerations are discussed below.

[83] *International Shipping Co (Pty) Ltd v Bentley* 1990 (1) SA 680 (A) at 700E – I.

[84] *Fourway Haulage* above n9 para 30.

[85] *Mcubed International (Pty) Ltd and another v Singer and others NNO* 2009 (4) SA 471 (SCA) para 27.

[86] *Country Cloud* above n21 para 25.

[87] *Cape Empowerment Trust Ltd v Fisher Hoffman Sithole* 2013 (5) SA 183 SCA para 35.

[88] Ibid para 36.

It therefore happens that conduct which is found to have been wrongful, negligent and even the factual cause of the loss in question, is held to be too remote for the defendant to be held liable.[89]

The issue of causation was considered in the context of phishing in *Nashua Mobile (Pty) Ltd v GC Pale CC t/a Invasive Plant Solutions.*[90] Nashua had issued a duplicate SIM card to a fraudster who then gained access to the account of the victim at Nedbank and performed a series of fraudulent electronics funds transfers. The victim sued Nashua in delict for the loss. On appeal from the magistrates' court it was found that because a contractual relationship between Nashua and the victim existed, delictual liability was not competent. More importantly, for present purposes, the court found that it had in any event not been established that Nashua was the cause of the victim's loss. The court held:

> *"If, as Albertyn and Kuyler testified, no access can be gained to the plaintiff's [the victim's] account via the internet through SIM card alone, then it seems to me that the defendant's [Nashua's] negligent omission cannot reasonably be said to be the proximate cause of the plaintiff's loss. In the absence of any explanation as to how the fraudster could have obtained the plaintiff's or Barbara's*[91] *profile number, PIN number and password, the only logical answer would seem to me to be that either Barnard or Kuyler (the only people at plaintiff who have access to the account) did receive the email and click on the link described by Albertyn (but genuinely does not recall), or the fraudster received a helping hand either inside the bank or inside the plaintiff from someone or people who had that information. The only other explanation, postulated by Albertyn but promptly dismissed by him as being unlikely, is that the fraudster was 'extremely lucky' to be able to guess the profile number, PIN number and password together".*[92]

These conclusions can conceivably be extended to the beneficiary bank: because access cannot be gained to the account without the security details, any wrongful and negligent conduct on the part of the beneficiary bank in opening the beneficiary account in question cannot reasonably be said to be the proximate cause of the victim's loss. This is particularly so where an account (whether an existing account or an account that has been specifically opened for that purpose) has been "sold" by the holder thereof to the fraudster. The case studies show that often beneficiary accounts are operated regularly for extended periods of time, even years, before pressed into service for phishing fraud. Where newly opened accounts are used the account holder may or may not be in collusion with the fraudster. It is not necessarily the case, as was found in *Energy Measurements* in the context of stolen cheques:

> "*that the opening of the account and the depositing of the cheques were part and parcel of the same fraudulent scheme and having regard thereto that the opening of the account was the*

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89 See for instance *International Shipping* above n83.

90 2012 (1) SA 615 (GSJ).

91 This appears to be a typing error, and that the court was referring to one Barnard, an employee of the victim.

92 *Nashua Mobile* above n90 para 32.

> *first and indispensable step in obtaining payment on the basis of the stolen cheques, a direct and causal link is established between the bank's negligence and the loss that was suffered".*[93]

Of greatest interest, however, is the implicit suggestion in *Nashua*[94] that if the victim clicks on the email link, i.e. the link in the email from the fraudster that takes the victim to the false website (which then causes the security details of the victim's account to be revealed to the fraudster), causation between any negligence on the part of a third party and the victim's loss would not be established. No doubt this will be a hotly debated issue if and when the liability of a beneficiary bank in the context of phishing comes under the scrutiny of the courts.

Negligence on the part of the victim

Wrongfulness, negligence (on the part of the beneficiary bank) and causation are not the end of the enquiry. Possible contributory negligence on the part of the victim and apportionment of damages in terms of the Apportionment of Damages Act,[95] section 1 must also be considered. [96] Although contributory negligence and legal causation must be carefully distinguished,[97] often the same facts which are considered under the rubric of causation will be relevant to negligence on the part of the victim, with the qualification that not every negligent act of a plaintiff related to his damage is relevant for the purposes of the Apportionment of Damages Act.[98]

Banks are obliged to ensure that their customers' information is secure.[99] They are also obliged to install and maintain a reasonably efficient security system and ensure that the system is operating efficiently.[100] On the other hand, customers also have duties. The first and foremost of these is to keep their security details confidential. Customers must also inform their banks when their security details are compromised. These obligations are

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[93] *Energy Measurements* above n63 para 141.

[94] *Nashua Mobile* above n90 para 32.

[95] Act 34 of 1956.

[96] Subsection 1(1)(a) reads as follows: "*Where any person suffers damages which is caused partly by his own fault and partly by the fault of any other person, a claim in respect of that damage shall not be defeated by reason of the fault of the claimant but the damages recoverable in respect thereof shall be reduced by the court to such an extent as the court may deem just and equitable having regard to the degree in which the claimant was at fault in relation to the damage*". Subsection 1(1)(b) then says: "*Damage shall for the purpose of paragraph (a) be regarded as having been caused by a person's fault notwithstanding the fact that another person had an opportunity of avoiding the consequences thereof and failed to do so*".

[97] Neethling & Potgieter above n8 at 176.

[98] Ibid at 176.

[99] See, for instance, Van der Bijl above n40 at 165.

[100] Malan, Pretorius & Du Toit above n2 para 209.

typically imposed in terms of the agreement between the customer and his bank which regulates the internet banking functionality.[101] Such standard agreements may also contain stipulations to the effect that the customer acknowledges that the bank is not obliged to inquire into the authority of the person who uses the internet banking services extended to the customer.[102]

These contractual measures do not mean that banks could be, and are, indifferent to the risks of phishing.[103] Banks warn their customers against the risks of phishing.[104] Precautionary measures are recommended by banks to their customers to avoid falling prey to phishing attacks.[105] Banks also employ measures (as they are obliged to do) to enhance the security of internet banking.[106]

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[101] For example, Standard Bank's Electronic Banking Agreement (available at (https://www9.encrypt.standardbank.co.za/ibsa/InternetBanking, accessed on 4 May 2015) says the following, in clause 9 "*Looking after your access codes: Your access codes are any of your secret numbers (PIN or CSP), ATM card numbers, passwords or user names. We may allow you to use the same access codes for all Electronic Banking or related services because this is easier for you. But you must keep your access codes very safe because someone who knows them could get access to your Account and steal your money or use your private Account information illegally. You must always look after your access codes and keep them secret. If you do not, you waive any claim you may have against us for any loss or damage you may suffer because you have not kept them safe. It is not safe to keep your access codes on a computer*. *No person ever has a genuine reason to know or ask for your access codes, so you must never let anyone get them. This includes our own staff. You must immediately tell our Customer Contact Centre or your branch if someone has asked you for any access code or may know it*".

[102] Standard Bank's agreement is again used as an example. It says, in clause 12: "*We may assume that you have authorised any instruction - After your access code has been entered, we may assume that any Electronic Banking activity or instruction is genuine. So even if someone else used your access code, we may carry out an instruction as if you have authorised it*".

[103] Cassim above n37, says (at 410) that "*banks can become more pro-active by addressing the problems, by investigating solutions and investigating filter controls and introducing best practices for online marketing*."

[104] The major banks, including Capitec, have prominent warnings on their internet banking landing pages. By way of example: Capitec (https://direct.capitecbank.co.za/ibank/, accessed on 5 May 2015) says, under the heading "*SECURITY BASICS*": "*1.We will NEVER ask you for your Remote PIN, password or token passwords by email, SMS or telephone 2. ALWAYS keep your username, Remote PIN, password or token passwords secret 3. NEVER use a link or an attachment in any message to access Remote Banking 4. ALWAYS check that the website address bar and certificate both match capitecbank.co.za Check your accounts often and report any suspicious activity immediately on 0860 10 20 43*". Nedbank (https://netbank.nedsecure.co.za, accessed on 5 May 2015) says, under a prominent heading "*SECURITY ALERT*" next to a warning sign: "*Nedbank will never ask you to access internet banking through a link in an email. Click here for more info. Click here for info on how to verify this website. Nedbank will never ask for your mobile number when you access internet banking*". See also *Roestoff* above n31 par 9 – 11 about ABSA's warnings.

[105] For instance, Standard Bank says: *"Never give your personal details to anyone without verifying their identity. You should view emails and pop-up windows asking for your personal information with the same amount of suspicion you would the person behind you in an ATM queue.*

- *Treat emails that appear to be from us asking for personal details with suspicion.*
- *Never provide your personal details, for example, your PIN or account details*

In the face of the efforts, on the part of banks, to bring the risks of phishing to the attention of their customers, a victim who discloses his security details in a phishing scam is, arguably, negligent (to a greater or lesser degree). In *Roestoff,*[107] although the defendant was held not to have been negligent so that a consideration of the contributory negligence of the victim was unnecessary, the court nevertheless remarked on the conduct of the victim. The court said the victim's failure (by his own admission) to have read the security warnings on ABSA's internet banking site was in itself negligent. The court further said that the victim had disclosed his security details, required to access his internet banking account, through a phishing scam. It was thus found that the victim's negligence had contributed to his loss.[108]

One accepts that the boundless ingenuity of fraudsters may make the deception hard to detect. Nevertheless, it is rudimentary that fraud as result of phishing cannot occur unless the fraudster is in possession of the security details of the victim's account[109] and that the fraudster cannot obtain those details unless they are revealed by the victim in some manner. "*Phishing works if the recipient of the bogus email acts on the message it transmits.*"[110]

Joint wrongdoers

Finally, the liability of joint wrongdoers [111] (with the beneficiary bank) is considered briefly. Contenders are the fraudsters themselves and possibly account holders who sold their

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- *Do not follow any links or open attachments in emails that directs you to our Internet Banking website. Always enter our website address (www.standardbank.co.za) in the address bar to connect to our Internet banking site.*
- *Do not create shortcuts on your desktop to Internet Banking. Malicious software could redirect the shortcut to a fake site.*
- *Always read the content of the One Time Password message sent to you*
- *Download the Trustee Software*
- *Ensure that all your contact details are correct*
- *Register for My Notifications and My Updates*"

(http://www.securitycentre.standardbank.co.za/scams/phishing.aspx, accessed on 5 May 2015).

106 To use Standard Bank as an example again: "*We are committed to protecting your banking details and are always on the lookout for sites that pretend to represent Standard Bank or any of our subsidiaries. We take immediate measures to close down fake websites and create awareness about the latest criminal activities*". (http://www.securitycentre.standardbank.co.za/scams/phishing.aspx, accessed on 5 May 2015).

107 Roestoff above n31.

108 Ibid para 93.

109 This seems to be commonly accepted. See also *Nashua Mobile* above n90 para 21.

110 Cassim above n37 at 406 - 407.

111 Subsection 2(1) of the Apportionment of Damages Act: "*Where it is alleged that two or more persons are jointly or severally liable in delict to a third person (hereinafter referred to as the plaintiff) for the same damage, such persons (hereinafter referred to as joint wrongdoers) may be sued in the same action*."

accounts to the fraudsters. However, as has been aptly put, "[*v*]*ctims usually tend to go for the one with the deep pockets*".[112] The deep-pocketed ones are not only the banks. Mobile phone service providers eminently also qualify. In this regard, Van der Bijl[113] says:

> "*In the case of SIM-card swapping, it is the mobile cellular electronic communications service provider who issues the SIM-card and not the bank. If the failure is outside the bank's control but within the control of the mobile cellular electronic communications service provider as in the case of a swapped SIM-card, one would be hard-pressed to hold the bank solely liable in such cases. It would appear that some of the risk allocation would point towards the mobile cellular electronic communications service provider who should also exercise reasonable care and skill in the issuing of SIM-cards".*[114]

Van der Bijl wrote before the decision in *Nashua Mobile*[115], in which it was found that the mobile phone service provider was not the proximate cause of the victim's loss. It is submitted, however, that the last word on the delictual liability of mobile phone service providers has not been spoken.[116]

<u>Grounds on which it has been suggested that the beneficiary bank may be held liable: monitoring of client's accounts.</u>

Another ground which has been mooted for the imposition of liability on a beneficiary bank for loss arising from phishing relates to the monitoring of customers' accounts. The *fons et origo* for this proposition is what will be called, for the sake of convenience, "the Zamzar case".[117] Lawack and Pretorius say that the importance of this case lies therein that, for the first time, there is even a hint that there might be a duty on a collecting bank to monitor the banking activities of its client.[118]

The plaintiffs were defrauded in a scheme in which a company known as Zamzar Trading (Pty) Ltd ("Zamzar"), that held an account with ABSA, was used to claim VAT refunds on non-existing transactions. The plaintiffs paid an amount in excess of R48 million to Zamzar, over a period of some 13 months, which was withdrawn almost entirely in cash, sometimes as much as R7 million at time. The plaintiffs sued in delict, claiming (among

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112 Lawack & Pretorius above n6 at 105.

113 Van der Bijl above note 40.

114 Ibid at 167.

115 Nashua Mobile above n90.

116 It should be noted that the Regulation of Interception of Communications and Provision of Communication-Related Information Act 70 of 2002 imposes duties on mobile phone service providers to, among others, keep records of customers' details. Certain offences are created, notably if a SIM-card is swapped or activated without proper verification of the identity of the party to whom the card is issued. The Electronic Communications and Transactions Act 25 of 2002 may also be relevant.

117 *Commissioner, South African Revenue Service* above n71.

118 Lawack and Pretorius above n6 at 111.

others) that ABSA had been negligent in opening the account for Zamzar and also, more pertinent for present purposes, that ABSA owed the public and the plaintiffs a duty to "*query the source of each of every debit and credit where very large sums emanating from the first and/second plaintiffs in particular were paid into accounts and withdrawn, mainly in cash shortly thereafter*".[119] ABSA excepted to the plaintiff's particulars of claim, amongst others on the basis that the plaintiff contended for a duty of care which was "*an impermissible extension of the provisions of the lex Aquilia to the present case of pure economic loss".*[120]

The court found a number of considerations relevant to the policy decision and value judgment necessary to decide whether a legal duty, both in relation to the opening and conduct of the account, is established:

- the plaintiffs would not know that a fraud was being committed on them whilst ABSA knew that the Zamzar account was essentially funded by VAT repayments, and also that the account showed no transactions which necessarily must have taken place if Zamzar genuinely bought and sold goods (which would give rise to VAT refunds);[121]
- with regard to the argument of indeterminate liability, that the extent of the potential loss is finite and the potential claimants are predictable;[122]
- ABSA had a statutory duty to report suspicious activity under the Proceeds of Crime Act 1996 (which was in force at the time), which is a consideration to take into account but has little persuasive weight;[123]
- "*society's notion of justice demands that a bank should not turn a blind eye to the possibility that a customer may be using an account concluded with it for criminal purposes".*[124]

A consideration of these factors supported the existence of a legal duty on the part of the bank to avoid causing the plaintiffs pure economic loss by negligently opening and maintaining the Zamzar account. On exception, however, a final balancing and evaluation of all the relevant policy considerations could not be undertaken.[125]

> "*It is not possible without evidence to determine how great a burden recognition of the legal duties contended for will place on the bank. I am not in the position of the Court in the KwaMashu case who had the benefit of detailed evidence on such issues … I am unable to make a finding as to whether or not, for example, the second defendant follows procedures to*

[119] Ibid para 12.

[120] Ibid para 19.3.

[121] Ibid para 46.2.

[122] Ibid para 46.3.

[123] Ibid para 46.4.

[124] Ibid para 46.6

[125] Ibid para 47.

> *monitor accounts, the purpose of such monitoring and what such monitoring, if any, indicates".* [126]

The same issue arose in *Peterson and Another NNO v ABSA Bank Ltd,*[127] also in exception proceedings. Again it was found, after consideration of some policy factors (which essentially proceeded along the same lines as those expressed in the Zamzar case[128]) that the element of wrongfulness had been prima facie established[129] but that a decision could not be reached (in the absence of evidence or factual material) on exception.[130]

Lawack and Pretorius also refer to *ABSA Bank Limited v Lombard Insurance Co Ltd*[131] and *Nissan South Africa (Pty) Ltd v Marnitz NO (Stand 186 Aeroport (Pty) Ltd Intervening)*[132] which, although neither are in point,[133] have an underlying factual feature in common, namely that there were extraordinary credits to bank accounts. This prompts the authors to ask some questions:

> "*Surely, when millions of Rands unexpectedly poured into these accounts, converting debits into substantial credits, the bank's suspicions as to the source of these windfalls should have been raised?"* [134]
>
> and
>
> "*Surely with all the expertise that it available and the modern computer technology, the collecting bank should have known that there was something happening that was out of the ordinary. It must surely be possible to set up some computer program to monitor "*extraordinary*" movements on an account*." [135]

They then conclude:

> "*There is perhaps also a case to be made out that bank should take steps to monitor some bank accounts especially if there is some ground to suspect "irregular" or out of the ordinary movements in the bank account".* [136]

It is submitted that the consideration of wrongfulness where a beneficiary bank allegedly negligently failed to prevent phishing fraud by monitoring its customers' accounts will raise

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[126] Ibid para 49.

[127] 2011 (5) SA 484 (GNP).

[128] *Commissioner, South African Revenue Service* above n71.

[129] Peterson above n112 para 48.

[130] Ibid para 47.

[131] 2012 (6) SA 569 (SCA).

[132] 2005 (1) SA 441 (SCA).

[133] The former dealt with enrichment and the latter with a mistaken transfer of money.

[134] Lawack and Pretorius above n6 at 112.

[135] Ibid at 113.

[136] Ibid at 115.

some very difficult questions. One of these relates to the policy consideration of "vulnerability to risk":

> "*It is settled law that where a plaintiff has taken, or reasonably could have taken, steps to protect itself from or to avoid loss suffered, this is an important factor counting against a finding of wrongfulness in pure economic loss cases. In these circumstances the plaintiff it not* 'vulnerable to risk' *and so, it is reasoned, there is no pressing need for the law of delict to step in to protect the plaintiff from loss."*[137]

Fundamentally, loss due to phishing does not arise if the victim does not reveal his internet banking security details. Internet banking users are warned against this and educated how to recognise phishing attacks. The simple proposition that internet banking users could avoid loss by taking steps to evade phishing attacks should be weighed against the magnitude (and hence costs) of monitoring that may, conceivably, be required to effectively curb losses arising from phishing. The counterbalancing argument may be that the fraudsters are sophisticated and the stratagems employed by them so convincing that banks' monitoring is required to protect bank customers, as it were, against themselves.

Of course, if wrongfulness is established, all the other issues of causation, contributory negligence and joint wrongdoing must still be considered.

Conclusion

At present, a delictual claim against a beneficiary bank for loss suffered by a victim as a result of electronic funds transfer fraud, particularly phishing, is not recognised by our law. The case law relating to the liability of a collecting bank to the owner of a lost or stolen cheque is distinguishable. There is support for the proposition that some of the policy considerations applicable to the recognition of a duty on the part of a collecting banker should apply to the beneficiary bank. The prima facie existence of a legal duty on a bank (other than the collecting bank of a lost or stolen cheque) to avoid causing pure economic loss by negligently opening and maintaining an account has been recognised. It has been suggested that there may be a duty on a bank to monitor its clients' accounts. The question of wrongfulness in this context will be a very difficult one.

[137] *Country Cloud* above n10 para 51.

An overview of recent company law cases: a mixed bag of emerging clarity, lingering doubt and deepening confusion

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It is almost impossible to give a complete account of case law developments in the field of company law and corporate insolvency law within the space and time afforded. My selection focuses what may be particularly problematic in practice viewed from the perspective of the banking industry.

This year's update includes a large proportion of supreme court of appeal judgments. While one would expect increasing clarity now that the Companies Act 71 of 2008 is in its fifth year of operation, the interpretation of some provisions remains problematic and conflicting judgments are sometimes handed down in the same division of the high court.

This update commences with general company law matters before considering the deregistration and reinstatement of companies. Attention then moves to developments in business rescue, the articulation between business rescue and liquidation, and the winding-up of solvent and insolvent companies.

1 General company law

1.1 *Company Secretary of Arcelormittal South Africa & Another v Vaal Environmental Justice Alliance* 2015 (1) SA 515 (SCA); [2015] 1 All SA 261 (SCA)

This was an appeal against an order under the Promotion of Access to Information Act (PAIA), instructing Arcelormittal to provide the respondent with documents pertaining to its impact on the environment. The requested documents included a master environmental plan for the rehabilitation of a site from which the company conducted industrial operations, progress reports on its implementation and various reports, responses, applications and other documents exchanged between the company and the Department of Environmental Affairs and the Gauteng Department of Agriculture and Rural Development.

The respondent, a voluntary association formed to advocate environmental justice, argued these documents were required for the protection, in the public interest, of the constitutional right to an environment that is not harmful to health or well-being and the right to have the environment protected through legislative measures.

The company retorted that the respondent was trying to act as a parallel regulatory body seeking to monitor compliance of the statutory regime. It also urged to court to take into account that it was a private body and that the threshold for access to information held by it was higher than in respect of information held by the state.

The court remarked that this matter requires balancing the competing interests of environmental protection and of economic development through industrial activity. The preamble of PAIA recognises that a secretive and unresponsive culture existed in public as well as private bodies and that this often led to abuse of power and human rights violations. Private bodies and persons are expressly included in its ambit although in comparison to information held by the state, an additional standard applies in that the requester must show the information is required in order to protect a right. In considering whether the information is "reasonably required" the factual background is relevant. As such, the company's acknowledged history of operational impact is highly relevant. It is a major polluter in the area and its activities impact on the communities in its vicinity and also on the country as a whole.

The company's publicly stated commitment to engage with environmental activists, as proclaimed in a recent annual report, was also considered by the court. Against this background its allegation that the respondent now seeks to act as a regulatory authority raised doubts as to its sincerity and good faith. In the field of environmental protection, public consultation and interaction was recognised as important, as could be seen in several statutes such as the National Environmental Management Act, National Environmental Management: Waste Act and National Water Act. Public interest groups could, according to the court, make a significant contribution to promoting environmental rights. The court said that one could speak of "collaborative corporate governance" when it came to the environment. The limits to the principle of public participation and collaboration must be set by the courts through a common sense approach. The appeal was dismissed with costs and the court warned that corporations operating within South Africa should realise that there is no room for secrecy in relation to the environment in circumstances such as these.

This judgment shows that where a company has information that could reveal a link between its activities and the possible infringement of one or more fundamental rights, the provisions of PAIA can be successfully invoked by public interest groups to obtain a wide range of records. This might seem to open up the floodgates to applications for access to information compiled by companies, even if disclosure could incriminate them. But the court regarded a common sense approach to the normal threshold requirement - that the requester has to show the information is reasonably required in order to protect a right - as sufficient protection of private bodies. It also pointed out that access may be refused on various grounds set out in PAIA, including that access to commercial information may be refused if its disclosure could cause financial or commercial harm. The court did not refer to s 70 of PAIA which provides for mandatory disclosure, in the public interest, by a private body of records that could reveal substantial contraventions of the law or imminent or serious public safety or environmental risk. This provision overrides the normal grounds for refusing access, including the protection of commercial information.

The adverse remarks about the sincerity of the company's declarations on stakeholder engagement and environmental sensitivity might cause companies to think twice about what they include in their annual reports. The company referred to the master environmental plan in annual reports, so it had difficulty denying that it contained relevant information. And, having committed to engagement on environmental issues, it could hardly deny that its activities had an impact on the environment. Nevertheless, the outcome did not depend on a lack of sincerity or good faith on the part of the company, nor on its evasive and obstructive reaction to the request for information, which the court also criticised.

2 Deregistration and reinstatement

The low compliance rate for the submission of annual returns and the administrative deregistration of thousands of companies and close corporations has caused serious practical problems for corporate entities and their creditors. These difficulties have been compounded by legal uncertainty pertaining to the applicable procedures and their legal effect. Although some questions still need to be determined authoritatively, the SCA ruling on the effect of reinstatement and the powers of the court following a company's dissolution has introduced certainty on arguably the most pressing issue.

2.1 *Fintech (Pty) Ltd v Awake Solutions (Pty) Ltd & Others* [2014] 3 All SA 664 (SCA)

This was an appeal against the judgment in *Fintech (Pty) Ltd v Awake Solutions (Pty) Ltd & Others* 2013 (1) SA 570 (GSJ) which declared valid all actions by or against a company during the period of its deregistration. The judgment was handed down on the day ABLU 2014 was held.

Awake Solutions was provisionally liquidated in April 2008. There was confusion as to whether the provisional order was confirmed on the return day, as the court file could not be located. The SCA accepted that a final winding-up order was granted in July 2008. The Johannesburg High Court assumed that the provisional order was not confirmed, and it set aside the provisional order in October 2010. However, the company was deregistered in July 2010 for failing to submit annual returns. Fintech discovered this in March 2012. When the sole shareholder and director of Awake Solutions learnt of this, he approached the CIPC and the deregistration was subsequently "cancelled" by the CIPC in April 2012.

Fintech wanted to recover payments it *made* to Awake Solutions in 2011, arguing that they could not have been due while Awake Solutions did not exist. It also applied for the setting aside of a court order Awake Solutions obtained against it in 2011.

The court ruled that the final deregistration of the company was incompetent. When a company is in liquidation, the hand of the law is laid upon the estate for the benefit of the creditors generally, and the company remains in existence until its affairs have been completely wound up. An administrative act by the Commission cannot trump the continued existence resulting from the court's liquidation order. Such a deregistration during winding-up could be set aside on review. However, as the de registration in this case had been cancelled by the CIPC, there is no administrative act that can be set aside. It is also not necessary to reinstate or reregister the company as it never lost its status at any stage. The court found that the litigation by the company, and the payments made to it, all occurred while it had corporate status. The appeal was dismissed with costs.

It is disconcerting that a company's stakeholders could be unaware of its legal status, in this case whether it was fully functional, in final liquidation or final deregistration. But it makes sense that it should not be possible to administratively deregister a company while its affairs are being wound up. Although the Companies Act does not contain an express exception, the SCA's approach of relying on the *concursus creditorum* is to be welcomed.

2.2 *Newlands Surgical Clinic (Pty) Ltd v Peninsula Eye Clinic (Pty) Ltd* (086/2014) [2015] ZASCA 25 (20 March 2015)

This appeal judgment brings an end to the considerable uncertainty arising from conflicting judgments on the legal effect of reinstatement of deregistered companies. As the SCA remarked at [22]: "interpretations given to the section in the various decisions cover the whole spectrum from no restrospectivity on the one hand, to complete retrospectivity on the other, with the concept of partial retrospectivity in between".

While the appellant was deregistered, the respondent obtained an arbitral award against it and the deregistered company even pursued review proceedings and an unsuccessful appeal to an appeal panel. The company was later reinstated by the CIPC but there was a dispute as to whether this validated the arbitration proceedings. The court *a quo* in *Peninsula Eye Clinic (Pty) Ltd v* Newlands *Surgical Clinic and Others* 2014 (1) SA 381 (WCC) concluded that reinstatement had limited retroactive effect. The company's "corporate existence" was restored and it was revested with its assets, but its "corporate activity" did not revive automatically. Actions by and against the company during its deregistration could, however, be validated by the court in terms of s 83(4) and the court *a quo* thus declared the arbitration proceedings valid.

The court argued that the failure by the legislature to re-enact the express retrospectivity provision of the previous Companies Act can at most be a pointer to the interpretation of the new provision. While a change of wording usually indicates a change of intent, this is less significant where the new provision is contained in a completely new act with its own scheme. At the same time, the word "reinstatement" that replaced "re-registration" supports the notion of retrospectivity. Reinstatement without any retroactive effect would serve no practical purpose.

There is, according to the court, no logical basis for partial retrospectivity. The court *a quo* relied on the potential prejudice to third parties of automatic full retrospective effect. However, the invalidity of corporate activities during deregistration can be equally detrimental to third parties. Validation and non-validation thus cuts both ways. Instead of relying on the court's powers under s 83(4) to validate corporate activities during deregistration, a court could use this provision to prevent validation of a particular transaction that would cause hardship to third parties.

The court found no textual basis that could support the court *a quo*'s pragmatic distinction between the revestment of property on the one hand and the validation of corporate activities on the other. The only meaning s 82(4) can have, the court said, is that reinstatement has automatic retrospective effect in relation to property and activities.

The court further found that the administrative reinstatement of a company under s 82(4) does not affect the availability of relief under s 83(4). A court can grant relief in relation to the dissolution of a company "at any time" after the dissolution of a company. Any person prejudiced by the retrospective effect of reinstatement can thus approach the court to ameliorate the consequences.

3 Business rescue

3.1 Merits

3.1.1 *Newcity Group (Pty) Ltd v Pellow NO and Others* (577/2013) [2014] ZASCA 162 (1 October 2014)

This was an appeal against *Newcity Group (Pty) Ltd v Pellow NO & Others* [Case no 45437/12 28 March 2013] where the court rejected an application by a holding company to place its hotel owning subsidiary in business rescue. The application relied on the possible suspension or cancellation of existing agreements and on the hope of attracting third party financing. The applicant argued that liquidation would destroy the business and cause 140 job losses. It said that business rescue would save costs compared to liquidation and that the creditors would thus be better off in business rescue.

The SCA said that the purpose of business rescue must be either rehabilitating the company to continue on a solvent basis or ensuring a better return for creditors and shareholders. The prospect must be based on reasonable grounds. The third party offers of financing were not viable. Even if it could be shown that they were based on firm commitments, they would simply amount to a substitution of a different debtor in the place of the company in business rescue. The creditors would have to accept a prolonged repayment period, write off part of the debts due to them and forfeit their security. The company could not service its debt in the preceding three years, and it is clear it cannot be restored to solvency. The argument that business rescue would yield a better return for creditors is based on an unsubstantiated allegation that the liquidation costs would be higher than those of business rescue. The possible litigation costs arising from the suspension of agreements has not been taken into account and interest charges have also been overlooked. It seems likely that the hotel business could be sold as a going concern in a liquidation. Based on the valuation of the property by the applicant, which exceeds the value of the bank's secured claim, it must be accepted that in a liquidation the bank would be paid in full. This is far more than envisaged by the proposed offers. Clearly, neither the bank holding over 75% of the claims, nor the applicant as sole shareholder, would be better off under business rescue. The court saw this as a fundamental hurdle, because it meant there was no prospect of rescuing the company. Consequently the enquiry could not progress to the balancing of interests of stakeholders in the exercise of the court's discretion. The court dismissed the appeal with costs.

It is a good thing that the SCA has emphasised the distinction between establishing the basic requirements of business rescue and the balancing of policy objectives that becomes relevant only once the requirements have been proven. This protects creditors against abuse of business rescue proceedings.

The court's assessment of the relative position of creditors and shareholders in business rescue and liquidation respectively, is interesting. Although the court mentioned the shareholder in passing, it focused on the position of the major secured creditor. It assumed that the property could be sold for going concern value in liquidation and at a price equal to the valuation put forward by the applicant.

Clearly, an applicant relying on the prospect of a better return will have to present convincing evidence on the expected liquidation value. While an optimistic valuation of company property might support a business rescue order on the basis of restoring the company to solvency, it might have the opposite effect when reliance is placed on a better return to creditors.

3.2 Scope of the general moratorium

3.2.1 *Moodley v On Digital Media (Pty) Ltd & Others* 2014 (6) SA 279 (GJ)

In terms of an approved business rescue plan, the equity of ODM would be restructured so that the total stake of the existing shareholders would be reduced to 15% while StarTimes would acquire 20% and a new BEE investor 65% of the shares. The shareholders would also acquire shares in a new company that would take over the license and infrastructure held by ODM.

The plan was subject to several suspensive conditions, including the adoption of a new memorandum of incorporation and the conclusion of shareholders' agreements between the old and new shareholders regulating their shareholding. These conditions were expressly stipulated for the benefit of StarTime, who also had the right to waive compliance with them.

The applicant, the only shareholder who had voted against the business rescue plan, was excluded from participating in the negotiation and conclusion of the shareholder agreements. The remaining shareholders concluded agreements, and passed written resolutions to adopt a new memorandum and to authorise the repurchase and cancellation of the existing shares and the issue of new shares.

The applicant argued that the plan could not be implemented until his equity stake had been determined through negotiation leading to a unanimous shareholder agreement. He was of the view that the written resolutions adopted by the other shareholders were not in line with the business rescue plan which envisaged that StarTime would purchase 20% of the shares from the existing shareholders. The written resolutions provided for a buy-back by the company, followed by a re-issue of shares. According to the applicant, the share buy-back would violate the provisions of the Companies Act on distributions and share buy-backs.

The court was also asked to determine whether the proceedings were subject to the general moratorium on legal proceedings against a company in business rescue, in which case they could be brought only with the consent of the business rescue practitioner or the leave of the court.

The court pointed out that the moratorium concerns only proceedings against the company and its property. Business rescue proceedings as defined in s 128 comprise three elements: temporary supervision of the company and its affairs, a temporary moratorium, and the development and implementation of a business rescue plan. The temporary moratorium is not concerned with aspects relating to the temporary supervision or the development and implementation of a business rescue plan. Such proceedings are brought against the business rescue practitioner and the company in business rescue, not against the company and its property. As such, they can be brought without the permission of the business rescue practitioner or the leave of the court.

Upon a proper interpretation of the business rescue plan it sufficiently regulates the post-rescue level of shareholding of the applicant, said the court. It envisages a proportionate reduction of the percentage shareholding of the existing shareholders. This result is reflected in the new memorandum of incorporation and is in line with the business rescue plan.

The court remarked that the cancellation of shares and the issue of new shares are expressly contemplated in the business rescue plan. It appears that the buy-back was simply the procedure chosen by the practitioner to achieve the cancellation of shares and implement the new shareholding requirements of the rescue plan. The applicant's position as shareholder was not adversely affected by the use of a buy-back. The application was dismissed.

The court's interpretation of the extent of the general moratorium is to be welcomed. It expressly declined to follow the conflicting interpretation in *Redpath Mining South Africa (Pty) Ltd v Marsden NO* Case 18486/2013 14 June 2013 (GSJ). Hopefully other divisions of the High Court will follow this approach of a more restricted general moratorium. (See *Absa Bank Limited v Naude NO & Another* Case 66088/12 24 January 2014 (GNP) where the moratorium was interpreted to include proceedings objecting to a business rescue resolution or applying for the setting aside of the voting on a plan.)

Certain remarks made in the course of the judgment must be questioned. The court implied that a company in business rescue need not comply with the solvency and liquidity test when making distributions to its shareholders, as the company is then not under the control of its board but being supervised by the business rescue practitioner. This overlooks the fact that the practitioner assumes full management control "in substitution" for the board so that during business rescue any provisions referring to the board must be understood as referring to the business rescue practitioner. Certainly business rescue cannot be used as an excuse to distribute an insolvent company's assets to its shareholders through dividends and repurchases free from compliance with solvency and liquidity, while creditors remain unpaid.

Nevertheless, it seems likely that the term "buy-back" was being used loosely to refer to an "acquisition" by the company of its own shares without any consideration flowing from the company to the shareholders. If this was the case, the cancellation of the shares did not involve a "distribution" as defined and there was no need to comply with the solvency and liquidity test. But it would be necessary to comply with s 48 which prohibits a company from acquiring its own shares if it would no longer have shares in issue (or only redeemable or convertible shares or shares held by its subsidiary). The sequence followed in cancelling existing and issuing new shares may thus be important.

3.2.2 *Murray and Another NNO v Firstrand Bank Ltd* (20104/2014) [2015] ZASCA 39 (26 March 2015)

This case concerned the validity of the cancellation of an instalment sale agreement during business rescue proceedings. The purchaser, Skyline Crane Hire (Pty) Ltd, was in arrears with the monthly instalments and the bank gave notice of the cancellation of the agreement. The notice was dispatched on the same date as the company's board filed a business rescue resolution with the CIPC and was deemed to have been received by the company a few days later. The business rescue practitioner later consented to the repossession and sale of the goods. The proceeds covered the amount outstanding under the agreement and left a balance which the bank retained in set-off in respect of other amounts due by Skyline. Skyline was later placed in liquidation.

The liquidators argued that the cancellation and sale violated the general moratorium set out in s 133(1) of the Companies Act. They claimed payment to them of the full proceeds of the sale, relying on their rights under s 83 and s 84 of the Insolvency Act.

The moratorium extends to "legal proceedings, including enforcement action". The usual meaning of legal proceedings is a lawsuit. The inclusion of enforcement action under the generic phrase legal proceedings indicates that enforcement action is seen as a particular type of legal proceeding, and this meaning is supported by the reference to "commenced or proceeded with in any forum". The word "forum" usually refers to a court or tribunal. "Enforcement action" in s 133(1) thus contemplates formal proceedings ancillary to legal proceedings, such as the enforcement or execution of court orders through writs of execution or attachment. The words in s 133(1) cannot be stretched to include the unilateral act of cancellation of a contract.

Shortly before the hearing of the appeal the liquidators tried to introduce an argument based on non-compliance with s 134(1)(*c*), which provides that rights against any property in the lawful possession of the company may be exercised only with the written consent of the business rescue practitioner. The court ruled that this new cause of action could not be introduced at this stage. If this issue had to be considered, compliance with s 134(1)(*c*) would be a factual question. Nevertheless, it briefly alluded to the possibility that following cancellation, the company was no longer in lawful possession of the goods so that s 134(1)(*c*) would not apply. The court also raised the possibility that the practitioner's consent, although apparently not in writing, might nevertheless constitute substantive compliance with s 134(1)(*c*).

Some of the court's obiter remarks must be read with caution. In response to the liquidators' argument that the cancellation of contracts would result in the inevitable demise of the company in business rescue, the court referred to certain safeguards in Chapter 6. It said that by invoking the right in s 136(2)(*a*) to suspend the company's obligations under a contract, the practitioner could prevent a creditor from instituting action and repossessing or attaching property ([35], also see [39]). Bearing in mind that such a suspension can relate only to the obligations becoming due during business rescue proceedings, it will not prevent a creditor from cancelling on the basis of pre-commencement breaches. Suspension of the company's obligations can also not force the other contract party to continue performing under a contract with continuing or periodic obligations.

3.2.3 Other matters on the moratorium

The meaning of "legal proceedings, including enforcement action" was also considered in *Chetty t/a Nationwide Electrical v Hart NO and Another* (12559/2012) [2014] ZAKZDHC 9 (25 March 2014) which held that arbitration proceedings were not affected by the general moratorium. The court did not consider the purpose of the general moratorium but simply based its finding on a remark on the ordinary meaning of "legal proceedings" in *Van Zyl v Euodia Trust (Edms) Bpk* 1983 (3) SA 394 (T) as referred to in *Lister Garment Corporation (Pty) Ltd v Wallace NO* 1992 (2) SA 722 (D).

In *National Union of Metal Workers of South Africa obo Members and Motheo Steel Engineering CC* (J271/2014) [2014] ZALCJHB 315 (7 February 2014) the Labour Court held that the moratorium in s 133(1) does not prevail over the Labour Relations Act (see s 5(4)(*b*) of the Companies Act) and that it accordingly does not prevent a matter from being referred to a Bargaining Council for arbitration.

3.3 Sureties and business rescue plans

As explained in my 2014 update, the effect of implementation of a business rescue plan on the position of a surety was considered in *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd & Others* 2013 (6) SA 471 (GNP), where the court issued a declaratory order that the liability of sureties were unaffected, and in *DH Brothers Industries (Pty) Ltd v Gribnitz NO & Others* 2014 (1) SA 103 (KZP), where the court explained that the absence of an express statutory preservation of the liability sureties meant that the common law principles applied. Accordingly, if the plan provides for a discharge of the main debt, the accessory liability under the suretyship will also fall away. The decision in *Absa Bank Ltd v Du Toit & Others* [2013] ZAWCHC 194 (13 December 2013) is in line with that in *DH Brothers*.

3.3.1 *Tuning Fork (Pty) Ltd t/a Balanced Audio v Greeff and Another* 2014 (4) SA 521 (WCC)

A creditor applied for summary judgment against two sureties for a company in business rescue. The adopted business rescue plan provided for payment to creditors of 28,2 cents in the rand in full and final settlement of their claims. The sureties argued that they were discharged from liability.

The court explained that it was clear that the general moratorium in s 133(1) of the Companies Act 2008 did not in any way affect the liability of a surety as it operated like a defence in personam, protecting only the company against enforcement but without extinguishing the debt. However, the effect of an approved business rescue plan on sureties is a separate issue. It is significant that the Companies Act does not expressly preserve the liability of sureties upon implementation of a business rescue plan, while it does so in respect of the compromise provided for in the same chapter and in various other statutes dealing with forms of composition or compromise. The court thus found that the common law position on discharge of a surety applies.

At common law, a surety is released by a compromise, including a statutory compromise. A business rescue plan appears to constitute a statutory compromise, although there is some uncertainty as to whether the reference to a creditor "who has acceded to the discharge of the whole or part of the debt owing to that creditor" means that a creditor can prevent the discharge of debts upon implementation of a plan. The court nevertheless accepted that the plan had the effect of extinguishing the main debt. This automatically released the sureties.

The court did consider the possibility that the business rescue plan could provide for the continued liability of sureties. The court said that sureties were also creditors of the company and thus also bound by the plan. A plan could thus deal with the position of sureties on a tripartite basis.

3.3.2 *New Port Finance Company (Pty) Ltd and another v Nedbank Ltd; Mostert v Nedbank Ltd* Case no 30/2014 1 Dec 2014 (SCA)

New Port Finance and its sole director had bound themselves as sureties towards Nedbank for the indebtedness of two property development companies. The bank obtained judgment against each of these companies and the two sureties jointly and severally. Although provisional and then final liquidation order were made against the two principal debtor companies, they were subsequently placed in business rescue and plans were adopted.

The sureties sought an interdict preventing the bank form enforcing the judgments against them and from proceeding with sequestration and liquidation applications. They argued that the obligations of the principal debtors had been altered and that this also altered their liability as sureties. The principal debtors were given an extension of time and once the plan had been implemented the obligations would be discharged, they argued. The interdict would be conditioned upon proper implementation of the business rescue plans.

As the business rescue proceedings of one of the principal debtors had failed just before the appeal was heard, it became clear that the interdict in respect of the enforcement of the relevant judgment could not be granted. This basically determined the outcome.

The court nevertheless considered some of the general issues raised by the parties, stating what the result would otherwise have been. First, it said that the sureties' liability would not be affected by any compromise (regardless of whether under a business rescue plan or otherwise), because the extent of their liability had been fixed by the court order against them. Secondly, the court found that the deed of suretyship expressly preserved the liability of the sureties despite any extension of time or any compromise.

Towards the end of its judgment the SCA briefly considered the judgment in *Tuning Fork* (above). The court was not convinced that s 154 of the Companies Act 2008 effected a compromise of the debt. It explained that the reference to the inability to "enforce" a debt against the company could be interpreted as a restriction on suing the principal debtor rather than as affecting the existence of the debt. If this was the case, the surety would remain liable.

3.3.3 *Business Partners Limited v Tsakiroglou and Another* case no 17827/2014 (WCC) 13 May 2015 (unreported)

This was an application to sequestrate the estate of a surety for a close corporation that was in voluntary business rescue. The surety was the only member of the close corporation and had also bound himself towards the applicant as co-principal debtor. He opposed the sequestration application on the basis that he was neither indebted to the applicant nor insolvent. He argued that he had been released as surety due to the applicant's prejudicial conduct: (i) the fact that the applicant, holding 100% of the creditor voting interests in the close corporation, had voted against the business rescue plan; (ii) had subsequently intervened in the practitioners' application to have the vote on the plan set aside as inappropriate and (iii) had counter-applied for the liquidation of the corporation.

The application for the setting aside of the vote on the plan was pending in the Pretoria division of the high court, the practitioners having changed the corporation's registered office from Cape Town to Pretoria. The remarks of the court about the merits of the plan and whether the voting could be inappropriate were thus obiter. The court agreed with the applicant that the plan amounted to a disguised liquidation – the corporation's business was to rent out three properties all mortgaged to the applicant. The two residential properties were vacant and had been in the market for a few years while only 40 per cent of the commercial property was occupied. A demolition order had been issued in respect of an illegal structure erected on one of the residential properties. The plan envisaged that building plans would be submitted to regularise the structure. The properties would be marketed for

120 business days, after which a forced sale would take place. Different valuations of the properties were put forward by the respondent, leading the court to conclude that the prices the properties were expected to fetch under the plan were inflated. The applicant as mortgagee would also not agree to the sale of the properties under s 134(3), so the plan would be impossible to implement. The court also referred to the applicant's objection to the high fees charged by the practitioners and to their failure to investigate whether the respondent was involved in reckless trading of the corporation. The court was of the view that the applicant's vote could not have been inappropriate.

As to the allegation of prejudice, the court referred to *Absa Bank Ltd v Davidson* 2000 (1) SA 1117 (SCA) which held that the South African law of suretyship does not recognise a general prejudice principle. The prejudice that will release a surety must be a breach of a legal duty or obligation. Conduct falling within the terms of the suretyship agreement cannot constitute "prejudice". There was nothing in the applicant's conduct in relation to the business rescue of the principal debtor that could release the surety.

The court found that although the respondent had not committed an act of insolvency, the facts indicated that he was actually insolvent. It made a provisional sequestration order.

It would be a rather curious outcome if a surety could be released by the creditor's rejection of a plan that would, if accepted, have compromised the debt and released the surety. The applicant, as pre-condition for its approval, insisted on a provision in the plan that would expressly preserve the liability of sureties, but the practitioners did not oblige. It seems they instead bargained on forcing through a business rescue plan from which only sureties (and perhaps practitioners) could benefit.

Given the different approaches to applications to set aside the voting on a plan as inappropriate (see 3.4 below), as well as the diverging interpretations of "binding offers" (see eg *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd & Others* 2013 (6) SA 471 (GNP) and *DH Brothers Industries (Pty) Ltd v Gribnitz NO & Others* 2014 (1) SA 103 (KZP)), the practice of changing the registered office of an entity in business rescue creates considerable scope for forum shopping by business rescue practitioners.

3.4 Failure to publish a business rescue plan and rejection of a plan

3.4.1 *Copper Sunset Trading 220 (Pty) Ltd v Spar Group Ltd and Another* 2014 (6) SA 214 (LP)

This was an application to set aside the voting on a business rescue plan as inappropriate, as envisaged by s 153(1)(*a*)(ii) of the Companies Act 2008. Curiously, the application was brought by the company while only the business rescue practitioner or an affected person has standing under s 153.

The company was a retailer of hardware and building materials operating under the "Build It" brand owned by the Spar Group. Its board adopted a business rescue resolution. A business rescue plan as well as a revised plan had been rejected, the respondents having voted against it. In a liquidation the Spar Group was expected to get a dividend of 45 cents in the rand and concurrent creditors nothing. The court found that the Spar Group's "gunning for liquidation" was self-serving and unreasonable. The second respondent's rejection of the plan was found to be "irrational" as it would receive no dividend in liquidation.

The court accepted the view of the business rescue practitioner and his consultant that the company could still be rescued if post-commencement financing was obtained. Evidence of possible post-commencement financing was accepted by the court. The interests of the 52 employees also had to be taken into account, the court said.

It is evident that the court did not restrict its enquiry to the factors listed in s 153(7). By taking into account the likelihood of the company acquiring post-commencement financing and the interest of the employees the court in effect considered issues that are relevant when it initially considers an application for business rescue. I am not convinced that s 153(1)(*a*)(ii) warrants this.

3.4.2 *Shoprite Checkers (Pty) Ltd v Berryplum Retailers CC and Others* (Case no 47327/14) 9 March 2015 (GP)

This matter dealt with the effect of a failure to publish a business rescue plan within the prescribed time. A close corporation that had a franchise agreement with Shoprite was placed in business rescue by resolution. The practitioner did not have a business rescue plan published in time and asked creditors for an extension on the last day of the period allowed for publication. Shoprite, the largest creditor, refused an extension as it felt the corporation's continued trading would prejudice its rights under general bonds over the movables. Shoprite applied to have the resolution set aside, arguing that the failure to publish a business rescue plan automatically terminated the proceedings, but also relying on the fact that it would be just and equitable to terminate the proceedings. The business rescue practitioner submitted a business rescue plan, requesting the continuance of the proceedings. Further parties intervened to oppose the setting aside of the resolution and alternatively sought a new business rescue order or a liquidation order.

The court held that the failure to publish a business rescue plan in time did not automatically terminate the business rescue proceedings, but did constitute a ground for the setting aside of the proceedings. On this point it thus did not agree with *DH Brothers Industries (Pty) Ltd v Gribnitz NO & Others* 2014 (1) SA 103 (KZP).

In order to decide whether the business rescue proceedings should be allowed to continue, the court then considered the content of the plan proposed by the practitioner, concluding that it is unlikely to be approved by the majority of the creditor voting rights. It was also unlikely, according to the court, that the vote of the major creditor would be set aside as inappropriate. The court criticized the conclusion in the *Copper Sunset Trading* matter (above) that the interests of stakeholders such as employees could be considered in deciding whether voting on a plan was "inappropriate" and whether it was just and equitable to set it aside. The court emphasized that the enquiry should be viewed purely from the perspective of the persons who voted against the plan. As the court was not asked to set aside voting on a plan – the plan had not even been considered at a meeting – its detailed analysis of s 153(1)(*a*)(ii) was not directly necessary. But if the ultimate fate of the business rescue plan was so important it is surprising that the court did not consider the likely outcome of the other possible steps that could follow upon rejection of a plan.

The court concluded that the business rescue proceedings should not continue as there was no reasonable prospect of rescue. It issued a final winding-up order.

4 Articulation between business rescue and liquidation

4.1 *Richter v Bloempro CC and Others* 2014 (6) SA 38 (GP)

This was an application for a business rescue order against a close corporation. The corporation had already been placed in final liquidation on the basis of its inability to pay its debts.

The judge requested the parties to address the court on the standing of the applicant, who claimed to be employed as the corporation's general manager. The court accepted that the applicant remained an affected person despite the suspension of his service contract upon liquidation of the company. [The court expressly relied [13] on the fact that the contract was only "suspended" but not terminated.. This assumption is clearly wrong – the temporary suspension under s 38(1) of the Insolvency Act could be followed by termination under s 38(4) or automatic termination upon expiry of the 45-day period set out in s 38(9). The court's remarks [14] about continued employment are based on confusion with the position of directors which is the subject of the authority cited in support.]

A second issue identified by the court was whether it was at all possible to grant a business rescue order after final liquidation. How should the words "may apply…at any time for an order placing the company under supervision and commencing business rescue proceedings" be interpreted? The court found several indications that business rescue proceedings could only exist before liquidation. It relied on the definition of "financially distressed" which contemplates future inability to pay and future likely insolvency, explaining that in this case the corporation was found to be already insolvent when the liquidation order was granted. It also said that a final liquidation order strips the company of its legal status and that it is untenable to suspend a final order with "an interim order of business rescue" [18]. The court then turned to the meaning of "liquidation proceedings" as s 132(1)(*b*) clearly allows business rescue applications during such proceedings. Declining to follow *Absa Bank Ltd v Summer Lodge (Pty) Ltd* 2013 (5) SA 444 (GNP), the court based its interpretation on the absence of an express reference to a company already under liquidation or to the possibility of business rescue even after a final order. Although the court did not mention this, its judgment also conflicts with that of the same division in *Van Staden v Angel Ozone Products CC* 2013 (4) SA 630 (GNP) which was directly in point, as in contrast with the *Summer Lodge* case in which provisional orders had been made, the close corporation in the *Angel Ozone* matter was in final liquidation.

The court relied on the fact that s 132(2)(a)(ii) provides for the conversion of business rescue proceedings into liquidation proceedings, but not the other way round. This argument does not convince. First, there is the obvious problem that the concept "liquidation proceedings" in the context of s 132(2)(a)(ii) can certainly not include the legal proceedings leading up to the granting of an order and can further not easily be restricted to provisional liquidation as this would mean business rescue cannot be converted into final liquidation. Secondly, the purpose of s 132(2)(a)(ii) is simply to determine when business rescue proceedings end - it refers to conversion without really "providing" for it. One would not expect a reference to the conversion of liquidation proceedings into business rescue proceedings in a provision setting out how business rescue ends. Such a provision would have to be contained in s 132(1) which sets out when business rescue commences, and indeed, s 132(1)(*c*) refers to the making of a business rescue order "during the course of liquidation proceedings" (see also s 131(7) "at any time during the course of any liquidation proceedings"). The court apparently also overlooked the express reference in s 136(4) to the "conversion" of liquidation proceedings into business rescue proceedings. This provision contemplates that a liquidator has already been appointed and that work has been performed and expenses incurred by him. It would have been interesting to see how the court would justify an interpretation that the word "provisional" should be read into the expressions "liquidations proceedings" and "liquidator" in s 136(4).

4.2 *Ex parte Nell and Others NNO* 2014 (6) SA 545 (GP)

A company was in put into voluntary business rescue through a board resolution. Creditors obtained an order setting aside the business rescue resolution and finally winding up the company. An appeal was lodged against this order and the court had to determine whether the lodging of the appeal had the effect of suspending the order as envisaged by s 18 of the Superior Courts Act. The court held that the liquidation order was not suspended by s 18 of the Superior Courts Act. As the company is unable to pay its debts, s 150(3) of the Insolvency Act, read with s 339 of the Companies Act 1973, applies. It preserves the operation of a final liquidation order despite the lodging of an appeal (except that assets may not be realised without the consent of the debtor).

The order terminating the business rescue proceedings was also not suspended pending determination of the appeal. The reason is that s 132(2)(*a*) of the Companies Act of 2008, which prevails over the Superior Courts Act in the event of a conflict, expressly states that business rescue proceedings end when the court sets aside a business rescue resolution or when the court has converted the proceedings into liquidation proceedings.

The court ordered that the liquidators would have control over the company's assets pending the outcome of the appeal.

5 Solvent and insolvent liquidation

5.1 *Boschpoort Ondernemings (Pty) Ltd v Absa Bank Ltd* 2014 (2) SA 518 (SCA)

The company had been wound up by the court *a quo* as a solvent company. The ground for liquidation was that it was "just and equitable" as envisaged in s 81(1)(*c*)(ii) of the Companies Act 2008. The company admitted that it was commercially insolvent, but insisted that it was technically or factually solvent. It appealed the finding that its liquidation was just and equitable.

The court dismissed the appeal, but held that the court *a quo* had erred in applying s 81 of the Companies Act 2008. The SCA was of the view that the company should have been wound up as an insolvent company on the basis of its inability to pay its debts (s 344(f) read with s 345 of the Companies Act 1973). As the application was based on this ground in the alternative, the company's commercial insolvency and inability to pay its debts had been established in the court *a quo*.

The court found that the concepts of a solvent and an insolvent company, as they relate to whether the liquidation grounds in respectively the 2008 and 1973 acts apply, refer to commercial solvency or insolvency. It relied on the continued application of s 344(f) and s 345 as of the 1973 Act to conclude on the meaning of solvent and insolvent in the 2008 Act.

While the outcome is certainly convenient in this matter, as in the large number of liquidations based on a company's inability to pay its debts, the reasoning of the court must be criticised. It confuses the threshold requirement to determining which set of grounds apply (old or new act) with one of the grounds of the old act. Section 344(f), which makes a company's inability to pay a ground for winding-up, is not the only ground for the winding-up of an insolvent company. Section 344 sets out 8 grounds in total, and most of these have nothing to do with the company's commercial insolvency or inability to pay debts. Admittedly, several of these grounds have become anomalous in view of the repeal of the 1973 Companies Act, eg the ground relating to membership of a public company falling below seven. But to argue, as the court does at [20] that s 345, which has always applied only to establishing whether a company is unable to pay its debts for purposes of s 344(f), was retained for the purpose of determining which set of winding-up grounds would henceforth apply to a particular company is unconvincing. It would have been preferable to support the commercial solvency argument with reference to considerations outside the 1973 Companies Act, eg commercial convenience. It is also acceptable to hold that in cases where the ground for winding-up is s 344(f) inability to pay, the applicant will simultaneously establish the threshold requirement and the liquidation ground. But how would one determine whether a company is solvent or insolvent if the applicant relies on one of the other grounds in s 344? Must the applicant now send a demand or obtain a nulla bona return as envisaged in s 345, or prove that the company is otherwise unable to pay its debts? And how must an applicant establish that the company it wants to have liquidated under the 2008 Companies Act is commercially solvent?

Considering the retention of constructive notice for RF companies from a public policy perspective*

Natania Locke†

1 *Introduction*

The Companies Act 71 of 2008 saw the introduction of legislative measures to facilitate dealings between companies and third parties. Companies now enjoy the capacity of an individual, unless limited in the memorandum of incorporation ("MOI") of the company.[1] Even when such capacity is limited in the MOI, all third party effects of the limitation is voided.[2] A transaction outside the limited capacity of a company should only give rise to internal remedies, in other words, action against the directors by the shareholders personally or by means of the derivative action. Shareholders, directors and prescribed officers may restrain a company from acting contrary to a limitation of its capacity, but such action is without prejudice to the rights of a third party who obtained such rights in good faith and who did not have actual knowledge of the limitation of capacity.[3] Additionally, any such an action may be ratified by the shareholders of the company by way of a special resolution.[4] The possibility of ratification shows that in terms of the new company law regime a company always has the possibility of full capacity, even when limited in the MOI.

As far as authority to deal on behalf of the company is concerned, the Act retains the use of the common law *Turquand* rule,[5] but further includes an express provision to facilitate dealings with third parties. Section 20(7) provides as follows:

> "A person dealing with a company in good faith, other than a director, prescribed officer or shareholder of the company, is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew or

*The paper is based on "The Legislative Framework Determining Capacity and Representation of the Company in South African Law and its Implications for the Structuring of Special Purpose Companies" forthcoming (*SALJ*) and on "Comparative perspectives on dealings with special purpose companies with particular reference to the South African 'RF' company" a paper to be delivered at the Australian Corporate Law Teachers Association conference, 1 – 3 February 2015, Melbourne, Australia.

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[1] s 19(1)(*b*) of the Companies Act 71 of 2008 (hereinafter "the Act").

[2] s 20(1).

[3] s 20(5).

[4] s 20(2).

[5] s 20(8).

> reasonably ought to have known of any failures by the company to comply with any such requirement."

Section 20(7) is not a model of clarity.[6]

The Act abolishes the doctrine of constructive notice.[7] However, there are two exceptions, namely (1) that persons are deemed to have notice and knowledge of the provisions of 'RF' companies that the Notice of Incorporation or the Notice of Amendment drew attention to;[8] and (2) that persons are deemed to have notice and knowledge that the directors and past directors of a personal liability company are jointly and severally liable, together with the company, for any contractual debts or liabilities of the company that arose during their period in office.[9]

Special resolutions of the general meeting of shareholders no longer lend the benefit of constructive notice. Furthermore, a third party dealing with the company is not deemed to be aware of any restrictions in authority of directors to deal on behalf of the company that are contained in the MOI or company rules, unless somehow such restrictions could be interpreted as falling under the exception under (1) above.

This paper particularly considers the exception in (1) above. It considers the facilitation of third party dealings in the United Kingdom, Canada, New Zealand and in Australia, where the doctrine of constructive notice has been abolished without exception. It then considers what the practical effects of the retention of the doctrine for RF companies are and comes to the conclusion that it lends no real benefit.

2 *RF companies*

"RF" stands for "ring-fenced". At the outset is must be made clear that not all RF companies are special purpose companies. There is some indication that the RF provisions were initially conceptualised with the aim of facilitating special purpose companies,[10] but in the end the provisions of the Act were phrased in wider terms.[11]

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[6] See in this regard Delport "Companies Act 71 of 2008 and the 'Turquand' Rule" 2011 *THRHR* 132 and Jooste "Observations on the Impact of the 2008 Companies Act on the Doctrine of Constructive Notice and the *Turquand* Rule" 2013 *SALJ* 464.

[7] s 19(4). In terms of the common law doctrine of constructive notice, third parties were deemed to be aware of the content of the public documents of the company, notably its memorandum and articles of association. See *Ernest v Nicholls* (1857) 6 HL Cas 401; Blackman et al *Commentary on the Companies Act* (2012, Revision Service 9) 4-30 – 4-31; Cilliers et al *Cilliers and Benade Corporate Law* (2000) 190 – 191; Cassim et al *Contemporary Company Law* (2012) 179 – 181; Meskin et al *Henochsberg on the Companies Act 61 of 1973* (2011 Service Issue 33) 130.

[8] s 19(5)(*a*).

[9] s 19(5)(*b*) read with s 19(3).

[10] The "RF provisions" refer to ss 11(3)(*b*), 13(3), 15(2)(*b*) & (*c*), and 19(5)(*a*).

In its current form, any prohibition of the amendment of a clause of the MOI of a company, to which proper notice has been drawn in the company's Notice of Incorporation, will trigger the RF provisions. There need not be a restriction in capacity, nor does the prohibition of amendment need to refer to a restriction in capacity.

However, owing to the exceptions to the general provisions regulating third party dealings with companies that apply to RF companies, all special purpose companies will be structured as RF companies to obtain the benefit of these exceptions.[12] The requirements for RF companies, and the exceptions that apply to them, will now be discussed in more depth.

2.1 Requirements for RF companies

Section 11(3)(*b*) of the *Companies Act 71 of 2008* provides as follows:

> "… if the company's Memorandum of Incorporation includes any provision contemplated in section 15(2)(*b*) or (*c*) *restricting or prohibiting* the amendment of any particular provision of the Memorandum, the name *must* be immediately followed by the expression '(RF)' (emphasis added)."

Section 15(2)(*b*) provides that a company's MOI may contain any "restrictive conditions"[13] applicable to the company, as well as any requirement for the

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[11] The review of company law in South Africa commenced with a policy document published by the Department of Trade and Industry *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (2004) http://www.pmg.org.za/bills/040715companydraftpolicy.pdf. The Companies Act 71 of 2008 was finally signed into law on 8 April 2009 (GN 421 *GG* 32121 of 8 April 2009), but its commencement was postponed for at least a year (s 225 prior to amendment). The reason advanced for this postponement was to provide those who work with the legislation time to become familiar with its provisions (see Cassim et al (n 7) [1.1]). However, the commencement of the Act was postponed several times and it only finally commenced on 1 May 2011. The Companies Amendment Act 3 of 2011 was produced in the interim, which did far more than "rectify errors in the principal Act" (see par [1.2] of the *Memorandum of the Objects of the Companies Amendment Bill, 2010*). It included material amendments to some of the provisions of the Act, amongst which were amendments to the RF provisions. The Act commenced with these amendments having been incorporated. No explanatory memorandum was produced to explain the amendments to the RF provisions.

[12] The structuring of special purpose companies to make best use of the exceptions provided by the RF provisions is discussed in Locke "The Legislative Framework Determining Capacity and Representation of the Company in South African Law and its Implications for the Structuring of Special Purpose Companies" forthcoming (*SALJ*).

[13] This phrase is not defined in the Act, nor is it familiar to South African law from previous companies legislation or case law. Prior to its amendment, the section used the term "special conditions", which was considered under the Companies Act 71 of 1963, s 53(*a*) to refer to restrictions in capacity (see *Quadrangle Investments (Pty) Ltd v Witkind Holdings Ltd* 1975 1 SA 572 (A)). This is partly owing to the fact that special conditions were inserted in the old style memorandum of association, which only dealt with the capacity and powers of a company. The use of the new phrase implies, from an interpretation of statutes point of view, that the phrase must carry a different meaning to "special conditions". Furthermore, since there is now only one constitutive document for companies, namely the MOI, which deals with

amendment of such a restrictive condition additional to the normal requirements for amendment set out in s 16 of the Act.[14] The reader will notice that the wording of section 11(3)(*b*) makes no mention of the restrictive condition, but only of the restriction of amendment of the condition as set out in section 15(2)(*b*). It is therefore my opinion that a clause in a company's MOI restricting the capacity of a company that is not coupled with a restriction in the normal method of amendment of that clause will not suffice to trigger the RF provisions. This might have been an oversight, but in practice the amendment of such clauses are usually excluded, or are made subject to increased shareholder approval.[15]

Section 15(2)(*c*) provides that a company's MOI may prohibit the amendment of any particular provision in the MOI. The prohibition of amendment of the clause restricting the capacity of a special purpose company alone will therefore trigger the RF provisions, as will a prohibition of amendment of a clause restricting the usual authority of the directors of the company.

Section 11(3)(*b*) is put in peremptory terms. A company that contains a restriction in amendment of a restrictive condition additional to that stated in section 16, or that prohibits the amendment of any clause in its MOI, must add "RF" to its name. This is extremely important, because the addition of the expression "RF" to the name of a company is intended to put third parties dealing with the company on guard about the content of the provisions so entrenched. While the doctrine of constructive notice is otherwise abolished it has been expressly retained for purposes of RF companies. Section 19(5) provides that:

> "A person must be regarded as having notice and knowledge of any provision of a company's Memorandum of Incorporation contemplated in section 15(2)(*b*) or (*c*) if the company's name includes the element 'RF' *as contemplated in section 11(3)(*b*), and* the company's Notice of Incorporation or a subsequent Notice of Amendment has drawn attention to the relevant provision, as contemplated in section 13(3) (emphasis added)."

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capacity of the company as well as authority to act on behalf of the company, the previous restrictive interpretation cannot apply to the use of the term as it stands in s 15(2)(*b*). I therefore consider limitations of the board of directors' general authority to manage the business and affairs of the company also to be "restrictive conditions" for purposes of s 15(2)(*b*). See Locke (n 12) par [V(b)].

[14] A company's MOI may usually be amended by a special resolution of the shareholders of a company (s 16(1)(*c*)). The MOI may also be amended by way of a court order (s 16(1)(*a*)), and the board of directors may amend the MOI for purposes of adjusting the authorized share capital of the company, or the terms attached to previously unclassified but authorised shares (s 16(1)(*b*) read with s 36(3) and (4)).

[15] I have argued elsewhere that the approval of a debenture-trustee will also be an additional restriction within the meaning of the section. The inclusion of such a restriction should suffice to trigger the RF provisions. See Locke (n 12) par [V(a)].

It is therefore disconcerting that the Companies and Intellectual Property Commission ("CIPC") issued a Practice Note,[16] which implied that the use of the expression "RF" after a company name is discretionary and must be used sparingly. It is in fact compulsory when the circumstances in s 11(3)(*b*) are present, and must be used for the protection of both the company and third parties.

Constructive notice will be given to the relevant clause in the MOI of a company if it is an additional restriction of the amendment of a clause as provided for in section 15(1)(*b*), or if the amendment of a clause is prohibited. Additionally, the Notice of Incorporation, or a Notice of Amendment, must have included a prominent statement drawing attention to such a provision and its location in the MOI of the company.[17]

The lending of constructive notice to the relevant clauses in the company's MOI drastically alters the effect of the provisions on capacity and representation of companies when dealing with RF companies.

2.2 Third party dealings with RF companies

The provision in the Act that provides that a company has all the legal powers and capacity of an individual is an alterable provision. It therefore follows that the capacity and powers of a company may be restricted in the company's MOI. Section 20(1) removes the third party effects of such restrictions in capacity by providing that the contravention of such a restriction does not render any action of the company void for that reason only, nor can the action be held void on the basis only that the directors of the company could not have authority to authorise such an action.

This provision is not made dependent on a lack of actual or constructive knowledge of the third party who needs to rely on it. The addition of the "RF" expression to the name of a company will therefore not exclude the operation of section 20(1). If the company and the third party therefore stays the course, the transaction will proceed undisturbed, regardless that it is outside the capacity of the company. Unless the transaction, and the authority of the directors, is ratified by a special resolution of shareholders,[18] the directors who authorised the transaction outside the restriction in capacity will remain liable for any loss, damages or costs

[16] See Practice Note 4 of 2012 pars [4] and [5] available at http://www.cipc.co.za/index.php/legislation/practice-notes/. The Practice Note in general is not a model of considered legal interpretation.

[17] s 13(3).

[18] s 20(2).

sustained by the company as a direct consequence of the transaction.[19] Each shareholder, who suffered damages as a result of the transaction, will also be able to proceed personally against the directors.[20]

The position becomes more complicated when the company is restrained from continuing with the transaction. Section 20(5) provides that:

> "One or more shareholders, directors or prescribed officers of a company may apply to the High Court for an appropriate order to restrain the company or the directors from doing anything inconsistent with any limitation, restriction or qualification contemplated in subsection 2, but any such proceedings are without prejudice to any rights to damages of a third party who
> *(a)* obtained those rights in good faith; and
> *(b)* did not have actual knowledge of the limit, restriction or qualification."

The effect of the inclusion of the "RF" expression at the end of a company name is to put third parties on guard about the content of the RF provisions. Third parties are deemed to have notice and knowledge of these clauses. This means that third parties may not able to claim that they acted in good faith when they transacted with a company outside of the limitations, restrictions or qualifications contained in the RF clauses. The net effect is that a shareholder, director or prescribed officer of an RF company may apply to restrain the company from continuing with the transaction and the third party might not be able to claim damages. The transaction will not be void, owing to the application of s 20(1), but will be unenforceable if the order is granted.

Further implications follow when the RF provisions relate to restrictions in usual authority. Section 20(7) provides as follows:[21]

> "A person dealing with a company *in good faith*, other than a director, prescribed officer or shareholder of the company, is entitled to presume that the company, in making any decision in the exercise of its powers, has complied with all of the formal and procedural requirements in terms of this Act, its Memorandum of Incorporation and any rules of the company unless, in the circumstances, the person knew *or reasonably ought to have known* of any failures by the company to comply with any such requirement (emphasis added)."

Since the third party will be deemed to have notice and knowledge of the relevant clauses,[22] she will not be able to rely on this provision to hold the company bound to

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[19] s 77(2)(*b*)(iii) and 77(3)(*a*).

[20] s 20(6).

[21] See Locke (n 12) par [IV(a)] for a detailed discussion of this section.

[22] Apart from the constructive notice that the RF provisions lend to the clauses, "know" is defined in s 1 of the Act to include: " … that the person … was in a position in which the person reasonably ought to have (i) had actual knowledge; (ii) investigated the matter to an extent that would have provided the person with actual knowledge; or (iii) taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter." I am therefore of the opinion that even in absence of the

a transaction, where a director did not have authority owing to the content of the relevant clauses. Of specific importance here is where the authority of the board, and of any specific director, is expressly and completely excluded for certain transactions. The third party will then also not be able to rely on the common law *Turquand* rule, also referred to as the indoor-management rule, the application of which has been retained by the Act.[23] Additionally, the third party will not be able to claim that she acted in good faith when dealing with the company outside of the restrictions to which the RF provisions relate.

If the RF provisions are therefore triggered by a prohibition of amendment of a clause in the MOI that *excludes* the authority of directors to act in certain transactions, the lack of authority of the directors will offer a complete defence to the company.

2.3 Structuring a special purpose company

Special purpose companies should be structured as RF companies in order to gain the benefits described above.[24] I recommend both a restriction in capacity to the purposes for which the company is incorporated, as well as a separate exclusion of authority of the directors of the company to enter into any transaction that falls outside of the purpose for which the company is incorporated. In my opinion, both such clauses will be "restrictive conditions" as referred to in section 15(2)(*b*) of the Act. The clauses must either be subject to additional requirements for amendment to those set in section 16,[25] or their amendment must be completely prohibited.[26] It is recommended that exclusions of authority should be entrenched with a prohibition of amendment, so as to avoid an argument that "restrictive conditions" is limited to restrictions in capacity.[27]

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constructive notice provision in s 19(5)(*a*) a third party will have known of the restriction in the sense defined above when the "RF" expression is affixed to a company name.

[23] Section 20(8): "[Section 20(7)] must be construed concurrently with, and not in substitution for, any relevant common law principle relating to the presumed validity of the actions of a company in the exercise of its powers." Jooste (n 6) 474 argues that s 20(8) cannot refer to estoppel, because estoppel does not lead to the presumed validity of company actions. Both Jooste and Delport (n 6) 132 agree that s 20(8) refers to the common law *Turquand* rule.

[24] See also Locke (n 12) at par [V].

[25] s 15(2)(*b*) read with s 11(3)(*b*).

[26] s 15(2)(*c*) read with s 11(3)(*b*).

[27] Refer to n 13 where the uncertainty about the meaning of this phrase was explained.

I have argued elsewhere that the ratification of a transaction in breach of a restrictions in capacity, or of a restriction in authority, may be excluded in the MOI.[28] Section 20(2), which allows for the ratification of such transactions, is an unalterable provision of the Act. However, section 15(2)(*a*)(iii) provides that the MOI of a company may include any provision:

> " … imposing on the company a higher standard, greater restriction, longer period of time or any similarly more onerous requirement, than would otherwise apply to the company in terms of an unalterable provision of the Act."

I am of the opinion that the exclusion of the possibility to ratify a contravention of a limitation of capacity, or of authority, sets a higher standard or a greater restriction than the possibility to ratify such a contravention and therefore constitutes a valid provision in terms of section 15(2)(*a*)(iii). A breach of the restriction will then always lead to the potential liability of the directors who allowed the breach to occur. This directly benefits minority shareholders, [29] and may indirectly benefit other stakeholders in the company.[30]

The constructive notice that the RF provisions lend to the restrictive clauses may benefit the company when its shareholders, directors or prescribed officers apply to restrain the company from breaching the clauses. The third party may not be able to claim that she was acting in good faith and could therefore not be entitled to damages when the order is granted.[31] The third party will also not be able to rely on the provisions of section 20(7) to keep the company bound to a transaction in breach of a limitation of authority, since she may not have acted in good faith and would be considered to have acted with knowledge as defined.

It is recommended that the authority of directors to act outside the limited purposes of the company be completely excluded in the MOI. Such a restriction will also bar the third party from relying on the common law *Turquand* rule and the defence of estoppel.[32]

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[28] See Locke (n 12) at par [V].

[29] See s 20(6).

[30] Through the use of the derivative action. See ss 77(2)(*b*)(iii), 77(3)(*a*) and 165. One thinks here, for instance, of the position of debt instrument holders in a traditional securitisation scheme.

[31] s 20(5).

[32] The third party will not be able to assert that it was reasonable to believe that the person had authority to deal on behalf of the company, because (1) the third party is regarded as having knowledge of the limitation of authority as per the provisions of s 19(5)(*a*), and (2) the "RF" at the back of the company name puts the third party on guard about the existence of restrictive conditions in the MOI of the company. I therefore submit that such a third party will fail to show that the company made a legally relevant representation of authority as an

It is clear that the memorandum of incorporation of a special purpose company may be shaped to provide for the greatest possible protection of the company against dealings in contravention of restrictions in capacity and of dealings in contravention of limitations in authority. However, the RF provisions and the retention of constructive notice to serve them are unique to South Africa when compared to the other commonwealth jurisdictions surveyed. These provisions are also at odds with the general approach of the rest of the Act.

3 *Comparative perspectives*

English law remains instructive to South African company lawyers, as local company law legislation was initially based on the English law example.[33] For the latest round of company law reform, principles from Canadian, New Zealand and Australian company law were also incorporated into the new Act. English, Canadian, Australian and New Zealand law is therefore instructive to South African courts and appropriate for comparison.[34]

Development of the regulation of third party dealings with companies shows great similarity across the surveyed jurisdictions.

3.1 United Kingdom

This area of law in the United Kingdom has been substantially influenced by article 10 of the *First Company Law Directive 2009/101/EC* of the European Union.[35] Article 10(1) provides that acts by the organs of a company shall be binding, even when they fall outside a restriction of the objects of that company. Member states are allowed to provide in their domestic legislation that the company will not be bound in these circumstances if the third party knew of the restricted objects, or if the circumstances were such that she could not have been unaware of it. However, disclosure of the statutes of the company is not in itself proof of such knowledge. Article 10(2) provides that:

> "The limits on the powers of the organs of the company, arising under the statutes or from a decision of the competent organs, may not be relied on as against third parties, even if they have been disclosed."

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essential element of estoppel. On this requirement of estoppel in South African law, see Sonnekus *Rabie and Sonnekus the Law of Estoppel in South Africa* (2012) 102-121.

[33] 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 Cilliers (n 7) 18–28.

[34] See also s 5(2).

[35] See also Article 9 of the *First EEC Company Law Directive 1968/151/EEC*.

The United Kingdom Companies Act 2006[36] does away with the memorandum of association. The constitutive documents of a company consist of its articles of association and any resolutions listed in section 29.[37]

Companies in the United Kingdom enjoy unrestricted capacity, unless their capacity has been restricted in the articles.[38] Even if restricted, the validity of an act of the company cannot be called into question because of a lack of capacity because of anything in the company's constitution.[39] Third parties no longer carry any constructive notice of the content of a company's constitution.

The third party effects of the *ultra vires* doctrine have been abolished in the United Kingdom.[40] Internally, however, the directors remain liable to the company to replace the money spent on such a transaction,[41] unless the transaction has been ratified.[42] Directors are subject to a statutory duty to act in accordance with a company's constitution.[43] Furthermore, they have a statutory duty to promote the success of the company, which by implication curtails the authority of directors so that they must exercise their authority in accordance with this duty.[44] An act or transaction outside the objects of a company may also fall foul of this duty, depending on the facts of the case.

The Companies Act 2006 does not contain any express provision enabling a member to restrain the company from doing anything inconsistent with a limitation of

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36 C. 46. The provisions below became operational on 1 October 2009.

37 s 17.

38 s 31(1).

39 s 39(1).

40 Birds (ed) *Annotated Companies Legislation*, (2010) par [4.39.05]; Davies, Worthington and Micheler *Gower and Davies' Principles of Modern Company Law* (2012) par [7.4]; Millet et al *Gore-Browne on Companies Volume 1* (2010) par [8.4].

41 s 171(1): "A director of a company must act in accordance with the company's constitution …". See also *Re Lands Allotment Co* [1894] 1 Ch 616; French, Mayson and Ryan *Mayson, French & Ryan on Company Law* (2012) par [3.8.2].

42 s 239. See further French (n 41) par [16.16.2]; Davies (n 40) par [7.30]; Millet (n 40) par [8.20]. Section 239 does not affect any rule of law as to acts that are incapable of being ratified by the company (s 239(7)). This subsection was interpreted in *Franbar Holdings Ltd v Patel* [2009] 1 BCLC 1 at [44] – [45] as preserving the principle that ratification is not possible where it is brought about by unfair or improper means or where it is illegal or fraudulent or oppressive towards opposing shareholders. It has further been held that the transaction to be ratified must have been bona fide or honest (*Bowthorpe Holdings Ltd v Hills* [2003] 1 BCLC 226 at [50]). See further French (n 41) par [16.16.4].

43 s 171.

44 s 172; *Hopkins v TL Dallas Group Ltd* [2005] 1 BCLC 543 at [88] and French (n 41) par [19.5.2.3].

objects. This was provided for before.[45] One view is that any member of a company may seek an injunction to bar the company from entering in a transaction outside of its restricted objects,[46] despite the omission of an express provision to this effect. Owing to the application of the provisions explained above, the repudiation of such transactions is doubtful. The authors of *Palmer's Company Law* seem to suggest that restraining action will no longer be available.[47] The Explanatory Notes to the Act explained that it was no longer necessary to include the provisions for restraining actions, because a company could now have unrestricted objects, and secondly because directors had a statutory duty in terms of the Act to act in accordance with the constitution.[48] However, the majority of authors agree that members will remain able to hold the directors to the company constitution in terms of the ordinary rules of the enforcement of the constitution.[49]

In *Gore-Browne on Companies* the authors hold the opinion that objects clauses will continue to be interpreted as before the *Companies Act of 2006* became operational.[50] In other words, the main purpose of the company must be ascertained, as well as any special powers needed to effectuate that purpose and any incidental or consequential acts to so effectuate the purpose.[51] One can see that where a company was incorporated before the new legislation became operative, and therefore already had objects clauses inserted in their constitutive documents, the previous interpretation of objects clauses would be appropriate. However, companies incorporated after 1 October 2009 specifically inserted *restrictions* of capacity into their articles, instead of stating a general object.[52] I would think that this implies that the restriction has to be interpreted conservatively, because it has to aim to protect the stakeholders of the company against acts outside those restrictions.

A person may bind a company if that person has express or implied authority to do so.[53] Directors' power to bind the company, or to authorise others to bind the

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[45] Companies Act of 1985, s 35(2).

[46] *Simpson v Westminster Palace Hotel Co* (1860) 8 HL Cas 712 (38 Law J Rep 561); French (n 41) par [3.8.2.2]; Birds (n 40) par [4.40.06]; Davies (n 40) par [7.4]; Millet (n 41) par [8.9].

[47] Morse et al *Palmer's Company Law: Annotated Guide to the Companies Act 2006* (2007) 83.

[48] at [123].

[49] see n 46 above.

[50] Millet et al, n 46 at [8.6].

[51] This is the classic statement on the interpretation of objects clauses from *Attorney General v Mersey Railway* [1907] 1 Ch 81 (CA) at 99.

[52] s 31(1).

[53] s 43(1)(b). See in general French (n 41) par [19.5] and Millet (n 40) par [8.12].

company, is deemed to be free of any limitations in the company's constitution, provided the person dealing with the company does so in good faith.[54] This provision effectively removes the need to rely on the common law *Turquand* rule.[55] A third party need not enquire whether there are any limitations on the powers of the directors to bind the company or to authorise others to do so.[56] She is not regarded as having acted in bad faith by reason only of knowing that the act is beyond the power of the directors under the company's constitution.[57] Lastly, she is presumed to have acted in good faith unless the contrary is proved.[58]

It is very difficult to see in what circumstances the third party will have acted in bad faith, when these provisions are taken into account as a whole. The standard commentaries on the United Kingdom Act seem uncertain as well.[59] An obiter dictum *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] BCLC 1 at 18 held that "a person acts in good faith when he acts genuinely and honestly in the circumstances of the case", but that it was not necessary to show that she acted reasonably as well.[60] However, in the context of an application for trade mark protection it has been held that although bad faith includes and element of dishonesty, it further includes an objective standard, namely whether the conduct is "acceptable commercial behaviour observed by reasonable and experienced persons in the particular commercial area being examined".[61] The courts have not yet expressly extended this view to the interpretation of section 40(1). What does appear certain is that actual knowledge of a lack of authority does not necessarily equal bad faith.[62]

A separate consideration is whether there is an "irreducible minimum" that has to be achieved before a person may rely on section 40. This question has

[54] s 40(1). This gives effect to article 10(2) of Directive 2009/101/EC.

[55] See French (n 41) par [19.5.4.5]; Morse (n 47) 84 and Birds (n 40) par [4.40.03]. Davies (n 40) par [7.28] argue that the *Turquand* rule retains more of its importance when the authority of a person other than the board of directors of the company is at issue. This is because s 40 might not be applicable to such a situation.

[56] s 40(2)(b)(i). Abnormal transactions or other circumstances that are suspicious may give rise to a duty to make enquiries. See in this regard *Hopkins v TL Dallas Group Ltd* [2005] 1 BCLC 543 at [94]; *Wrexham Association Football Club Ltd v Crucialmore Ltd* [2006] EWCA Civ 237 at [47].

[57] s 40(2)(b)(iii).

[58] This means that the company will carry the burden of proving that she acted in bad faith. See also Davies (n 40) par [7.10].

[59] See French (n 41) par [19.5.5.4]; Morse (n 47) 85 and Davies (n 40) par [7.10].

[60] Birds (n 40) par [4.40.05] accepts that subjective dishonesty is required.

[61] *Harrison v Teton Valley Trading Co Ltd* [2004] 1 WLR 2577 (CA) at [33].

[62] Davies (n 40) par [7.10].

surfaced in relation to inquorate boards taking decisions that could potentially affect third parties dealing with the company. It was considered in *Smith v Henniker-Major and Co* [2003] Ch 182 (CA),[63] but no final conclusion was reached in the decision. Walker LJ favoured the view that certain transactions would be a nullity without some basic requirements of the constitutive documents of the company having been met.[64] Carnwath LJ held that a contextual interpretation of the provisions pointed towards the rejection of this idea so that a third party dealing in good faith should be protected to the widest possible extent.[65]

The internal effects of an action that lacks the necessary authority are kept in tact by section 40(4) of the Act. Members retain the right to restrain the company from proceeding with an action that is beyond the powers of the directors, as long as it does not interfere with the fulfilment of a legal obligation arising from a previous act of the company.[66] This means that restraining action is only available when the directors are about to breach limitations of authority, but before they have actually entered into a binding obligation.[67]

The Act specifically provides for the possibility to entrench certain provisions in the articles of association. Entrenchment refers to any specified provisions of the articles that may only be amended or repealed if conditions are met, or procedures complied with, that are more restrictive than a special resolution.[68] Entrenchment is only possible if inserted in the articles on formation, or if all the members of the company agree to it.[69] Even if a provision is entrenched, all the members of the company may still assent to its amendment, and a court or similar authority retains the power to order an amendment of any provision of the articles.[70] The complete

[63] This decision considered the predecessor of s 40 in the *Companies Act of 1985*, s 35A.

[64] At [41] the "irreducible minimum" is described as: "a genuine decision taken by a person or persons who can on substantial grounds claim to be the board of directors acting as such, even if the proceedings of the board are marred by procedural irregularities of a more or less serious character. This is not a precise test and would have to be worked out on a case-to-case basis. But the essential distinction is between nullity (or non-event) and procedural irregularity." See further *TCB Ltd v Gray* [1986] Ch 621 at 637. Davies (n 40) par [7.13] and Millet (n 40) par [8.15] agree with this view.

[65] at [103] – [108]. French (n 41) par [19.5.5.3] agree with this view as corresponding more appropriately with the provisions of the Directive.

[66] Davies (n 40) par [7.15] and Millet (n 40) par [8.16].

[67] Davies (n 40) par [7.15].

[68] s 22(1).

[69] s 22(2).

[70] s 22(3).

prohibition of amendment of the articles is therefore not possible.[71] The Registrar must be informed if the articles contain a provision for entrenchment on formation, or if such a provision is inserted subsequently, or is subsequently removed.[72]

3.2 Canada[73]

A company in Canada has the capacity and powers of a natural person.[74] If the business or powers of a company is restricted in its articles, the company may not conduct any business contrary to the restriction or exceed the powers so restricted.[75] This is subject to the rule that no act of a company is invalid by reason only of the fact that the act is contrary to the company's articles or a provision of the Canada Business Corporations Act 1985.[76] A breach of a restriction may therefore give rise to internal remedies, but has no external effect.[77] At least one author holds the view that

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[71] The prohibition of amendment of the articles has never been possible in English law. See *Walker v London Tramways Company* (1879) 12 Ch D 705; *Malleson v National Insurance and Guarantee Corporation* [1894] 1 Ch 200; *Russell v Northern Bank Development Corporation* [1992] 1 WLR 588; [1992] 3 All ER 161 (HL).

[72] ss 23 and 24.

[73] The provisions discussed here are from the Canada Business Corporations Act of 1985, which regulates federal companies. However, these provisions are repeated mostly unchanged in the business corporations' acts of the individual provinces. See for instance the Ontario Business Corporations Act R.S.O. 1990, c. B.16, ss 15 – 19; the New Brunswick Business Corporations Act SNB 1991 c B-9.1, ss 13 – 16; Alberta Business Corporations Act R.S.A. 2000, c. B -9, ss 15 – 18; Saskatchewan Business Corporation Act R.S.S. 1978 c. B-10, ss 17 and 18; Manitoba Corporations Act R.S.M. 1987 c. C225, ss 15 - 18; Northwest Territories and Nunavut Business Corporations Act S.N.W.T 1996 c. 19, ss 5, 6, 10 and 14; Yukon Business Corporations Act R.S.Y. 1986 c. 15, ss 18 – 21 and 28; Newfoundland and Labrador Corporations Act R.S.N.L. 1990 c. C-36, ss 30 and 33 – 34. The British Columbia Business Corporations Act [SBC 2002] c. 57 contains substantially similar provisions regarding capacity (ss 30 – 33), but contains no abolition of constructive notice, nor does it reduce the effect of restrictions in the articles on dealings with third parties.

[74] Section 15(1) of the *Canada Business Corporations Act of 1985*, c.44; Buckley, Gillen and Yalden *Corporations Principles and Policies*, (1995) 177 – 178. There is one important restricting principle, namely that a corporation could not have greater capacity than the legislature that created it was constitutionally capable of granting. See in general Welling *Corporate Law in Canada: The Governing Principles* (1991) 226 – 227. An example is that provincial legislatures may not legislate on the operation of interprovincial railways, which means that it cannot authorise a corporation to operate one.

[75] ss 16(2) and 6(1)(*d*). This seems to suggest that a restriction of capacity is still possible, contrary to the view expressed in Welling (n 74) 220. Later this is qualified, namely that a restriction will only have internal effect (at 224).

[76] s 16(3). See further *Continental Bank Leasing Corporation v Canada* [1998] 2 S.C.R. 298, which considered the similarly worded provisions of ss 18(1) and 20(1) of the *Bank Act of 1985*, c. B-1.

[77] Welling (n 74) 224; Buckley (n 74) 177.

these provisions mean that the capacity of companies *to contract* may never be limited in Canada.[78]

No person is deemed to have notice or knowledge of any document by reason only of the fact that it has been filed or is available for inspection at the offices of the company.[79] The doctrine of constructive notice has therefore been abolished in Canada. The phrase "by reason only' implies that a person may be given notice in some other manner than by constructive notice.[80]

The board of directors of a company has the original authority to conduct its affairs.[81] Section 18 sets out the provisions dealing with the authority of directors, officers and agents to bind the company.[82] Neither the company, nor a person who guarantees an obligation of the company, may rely on the non-compliance of a provision of the articles, the company's by-laws, or any unanimous shareholders agreement against a person who acquired rights against the company.[83] The external effects of such limitations are therefore excluded. The section provides that persons with ostensible authority,[84] as well as directors, officers, agents and mandataries with actual or usual authority,[85] will bind the company against such persons.

If the person dealing with the company had knowledge of the restriction of the director, officer, agent or mandatary's authority, or ought to have had knowledge of such a restriction, because of her relationship with the company, the restriction may be used to escape liability.[86] It is not entirely clear from the provision whether the knowledge must have resulted from a relationship with the corporation, or whether actual knowledge obtained otherwise than through relationship with the company would suffice to exclude the availability of section 18. The general view seems to be that the restriction in section 18(2) must be interpreted restrictively, giving effect to

[78] Welling (n 74) 224.

[79] s 17.

[80] VanDuzer *The Law of Partnerships and Corporations* (2009) 216.

[81] s 102(1).

[82] See in general VanDuzer (n 80) 216 – 221 and Welling (n 74) 227 – 236.

[83] s 18(1)(*a*).

[84] s 18(1)(*d*).

[85] s 18(1)(*e*). See further Welling (n 74) 229 – 231. The representation that the company presented the person purportedly dealing on its behalf as its agent may have been made to anyone. It need not have been to the third party directly. The business conducted by the purported agent must have been usual for that particular corporation. The transaction must not have been out of the ordinary for the company, which might be rather harder to prove than one might think. See the examples provided by Welling (n 74) 232.

[86] s 18(2). See also Welling (n 74) 233 – 235.

the principle that third parties dealing with corporations need to have the confidence that their transactions in the ordinary course of business would be binding.

A director or officer who acts contrary to a provision in the articles, the by-laws or any unanimous shareholder agreement may be held liable for a breach of her duties.[87]

The articles, or a unanimous shareholder agreement, may require a greater number of votes of directors or shareholders than the Act requires to validate any action, in which case the provisions of the articles of the shareholders' agreement will prevail.[88]

A shareholder or a creditor may seek to enforce compliance with the Act, the articles, any by-laws, or any unanimous shareholders' agreements.[89]

The normal position is that the articles may be amended by a special resolution of the shareholders.[90] There seems to be no provision for the complete prohibition of amendment of the articles, which corresponds to the common law position.[91]

3.3 New Zealand

In general a company in New Zealand has full capacity to carry on any business or activity, and to enter into any transaction.[92] The constitution of a company may restrict its capacity, rights, powers or privileges.[93] There is no need for companies to state their objects in their constitution. If a company's capacity has been limited in its constitution, this alone does not affect the validity of an action in breach of such a restriction.[94] The external effect of a restriction in capacity is therefore excluded. The fact that an act is not in the best interests of the company does not mean that it does not have the capacity to enter into that act.[95]

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[87] s 122(2).

[88] s 6(3).

[89] s 247.

[90] s 173(1).

[91] see n 71 above.

[92] s 16(1). See in general Beck et al *Morison's Company and Securities Law Volume 2,* (1994) par [10.2]; Grantham and Rickett *Company and Securities Law: Commentary and Materials* (2002) 270 – 286.

[93] s 16(2).

[94] s 17(1); Beck (n 92) par [10.4]; *Westpac Banking Corporation v New Zealand Guardian Trust Co Ltd (No 2)* (1994) 7 NZCLC 260,507, and 260,513 – 514.

[95] s 17(3). See also Beck (n 92) par [10.6].

However, a shareholder retains the right to restrain the company from entering into a transaction in breach of such a restriction.[96] An order may only be made if it is in respect of conduct that has not yet been completed.[97] Action may therefore be taken even after obligations have arisen, but before completion of the contract. The court has the power to order consequential relief if the other party has suffered prejudice.[98]

Furthermore, actions in breach of a restriction of capacity by the directors of the company will constitute a breach of their duties, as well as a breach of the duty of the company to comply with the constitution.[99] The breach may therefore be raised in a derivative action,[100] a personal action against the directors,[101] and in an action to compel the directors to comply with the Act or the constitution.[102]

No one is deemed to have knowledge of the content of the company's constitution or any other documents filed on the register or available for inspection at the company's offices.[103] The doctrine of constructive notice is therefore abolished in New Zealand company law.

The board of directors have the original authority in terms of the Act to manage the business and affairs of the company.[104] The New Zealand Companies Act of 1993 has adopted a provision very similar to the Canadian Business Corporations Act of 1985, section 18.[105] Where the third party had actual knowledge of a restriction in capacity or authority,[106] or ought to have had knowledge as a result

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96 s 17(2)(a) read with s 164.

97 s 164(4); Beck (n 92) par [24.15].

98 s 164(3).

99 Beck (n 92) par [10.4].

100 s 17(2)(b) read with s 165.

101 s 17(2)(c) read with s 169.

102 s 17(2)(d) read with s 170.

103 s 19(1); Grantham and Rickett (n 92) 445.

104 s 128; Beck (n 92) par [25.9].

105 s 18. See the discussion in [3.2] above. See further Beck (n 92) par [25.22]. This provision is described as a "statutory estoppel against company pleading defects in agents power to bind company".

106 Beck (n 92) par [25.33] interprets actual knowledge as including when the missing parts of the third party's knowledge are obvious, or where their nature is probable and may checked easily. However, in line with the judgment *Brick & Pipe Industries v Occidental Life Nominees Pty Ltd* (1992) 2 VR 279, they do not consider actual knowledge to include having been put on inquiry. See further Grantham and Rickett (n 92) 446; Grantham "Contracting with Companies: Rule of Law or Business Rules?" 1996 *NZULR* 39 at 53 – 57. Grantham comes to the conclusion that the reforms introduced by the Companies Act 1993 did not effectively succeed in making third party dealings more certain and secure, partly because the courts

of her relationship with the company,[107] the company or a third party guarantor of an obligation will be able to assert the non-compliance with the provision of the constitution against the third party dealing with the company.[108]

The company, or a guarantor of an obligation of the company, may not assert against a person dealing with it that a provision of the Act or of the company's constitution has not been complied with.[109] The New Zealand provision goes further than the Canadian provision, in that non-compliance with a provision of the Act may also not be raised against the third person.[110]

It further provides that the third party may accept that the persons named as directors in the most recent notice received by the Registrar under section 159 are the directors of the company.[111] If any of those persons are not directors of the company, or have not been duly appointed, the company and its guarantors may not use this to escape liability. The third party may also accept that the named directors have the authority to exercise the powers that directors of a company carrying on the kind of business that the company engages in usually have.[112]

If the company holds out a person as a director, employee or agent, the company cannot raise a failure to duly appoint against a third person dealing with the company.[113] The third person may accept that such a person has the authority to exercise such powers as is usual for a director, employee or agent of a company engaged in the company's business.[114] Even if the purported director, employee or

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were cautious to extend third party protection further than that afforded by the common law (at 68).

[107] Beck (n 92) par [25.40]. This usually refers to insiders, such as directors, shareholders or employees of the company. However, being one of these persons does not necessarily bring one under the ambit of this provision – the facts of each case must be considered to ascertain whether the particular person had a close enough relationship with the company to ought to know who has authority to act on behalf of the company.

[108] s 18(1)(a). See also Beck (n 92) pars [10.7] and [25.27].

[109] s 18(1)(a).

[110] Beck (n 92) par [25.27] state that where the transaction is a major transaction, which requires additional approval by the shareholders, and the third party knew it to be a major transaction, he or she will not be able to rely on this provision. This is because the person that deals on behalf of the company must still have actual or apparent authority, which she will not be able to have without the additional approval. They follow the same reasoning to conclude that a third party will likewise not be able to use this provision to keep a company bound when the constitution provides for the possibility of an unusual delegation. The third party may not assume that such a delegation has been made.

[111] s 18(1)(b)(i) and (ii); Beck (n 92) par [25.28].

[112] s 18(1)(b)(iii).

[113] s 18(1)(c)(i); Beck (n 92) par [25.29].

[114] s 18(1)(c)(ii).

agent transacted with the third party in an act for which such a person would not usually have authority, but the company held out that the person had such authority, the company will be bound to the transaction.[115] This is basically a statutory statement of the principles of ostensible authority.

Section 18 expressly holds that the company and its guarantors will remain bound even if the purported director, employee or agent acted fraudulently, unless the third person had actual knowledge of the fraud. The use of documents forged to look as if they were signed on behalf of the company will also not exclude the applicability of the section.[116] Section 18 is not stated as a codification of the common law on estoppel or the *Turquand* rule. It is therefore argued that the common law remains available in such instances where the provisions of the section would not avail a third party.[117]

Section 32(2) provides that the constitution of a company may be altered by a special resolution of shareholders. While it is possible to set a more onerous requirement in the constitution for the alteration of certain clauses in the constitution,[118] it is excluded to prohibit the amendment of any clause in the constitution.[119]

3.4 Australia

Australian companies have the legal capacity of an individual.[120] A company has the legal capacity to transact even if the act does not serve the company's interests.[121] A company's constitution may contain a restriction on powers, or a prohibition to exercise certain powers. However, the exercise of a power so restricted or prohibited is not invalid *merely* because of the restriction or prohibition contained in the constitution.[122] The restriction therefore does not affect dealings with third parties without more.[123] A company may set out an objects clause in its constitution, but an

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[115] s 18(1)(d).

[116] See also Beck (n 92) par [25.41].

[117] Beck (n 92) par [25.220].

[118] Beck (n 92) par [9.9].

[119] Grantham and Rickett (n 92) 190.

[120] Corporations Act 50 of 2001, s 124(1). See in general Austin and Ramsay *Ford's Principles of Corporations Law* (2015) par [12.100]; Simmons, Pistilli and Cameron "Basic Features of a Company" in Austin (ed) *Australian Corporation Law Principles and Practice Vol 1* (Service 188) pars [2.3.0005] – [2.3.0015].

[121] s 124(2).

[122] s 125(1); Austin and Ramsay (n 120) par [12.150]; Simmons (n 120) par [2.3.0010].

[123] See also Austin and Ramsay (n 120) par [12.130].

act of the company is not invalid merely because it is contrary to such an objects clause.[124]

However, the act may still be voidable if there is an additional element of breach of a fiduciary duty of the directors present in the transaction. In this situation the transaction will not be invalid merely because of the restriction, but also because of the breach of duty of the directors.[125] One would not be able to rely on a lack of authority by reason of a lack of capacity of the company to invalidate the transaction, unless the third party knew or suspected that the person acting on behalf of the company did not have authority. Although not expressly stated in the Act, it seems as if a member could restrain a company from entering into a transaction contrary to the restriction of the company's capacity.[126]

Non-compliance with a limitation of a company's capacity or with a stated object is not a contravention of the Act, which means that a penalty cannot be imposed.[127] However, every member may enforce the statutory contract, including approaching a court for an injunction to prevent an action contrary to a provision of the constitution.[128] Non-compliance may further give rise to liability of directors for breach of duties, especially the duty of care and diligence.[129] The company may hold them liable for any loss suffered as a result of their actions.[130]

An individual may exercise the company's power to make, vary, ratify or discharge a contract with the company's express or implied authority.[131] The business of a company is managed through its board of directors.[132] The directors may exercise all the powers of the company, unless the Act or the company's constitution expressly provided that a specific power be exercised by the general

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[124] s 125(2).

[125] Austin and Ramsay (n 120) par [12.170]. See further *FAI Insurance Ltd v Urquhart (No 2)* (1986) 11 ACLR 38 at 41, affirmed in *Advance Bank Australia Ltd v FAI Insurances Ltd* (1987) 9 NSWLR 464 at 474G – 475B, 484G – 485F.

[126] See Austin and Ramsay (n 120) par [12.170].

[127] Austin and Ramsay (n 120) par [12.160].

[128] *Smolarek v Liwszyc* (2006) 32 WAR 129; 198 FLR 480 at [39]; Hambrook "Replaceable Rules and the Constitution" in Austin (ed) *Australian Corporation Law Principles and Practice Vol 1* (Service 188) par [2.4.0065].

[129] Austin and Ramsay (n 120) pars [12.150] and [12.160]. On the duty of care and diligence, see s 180(1) and Austin and Ramsay (n 120) par [8.305].

[130] See also Austin and Ramsay (n 120) par [12.180].

[131] s 126(1) and Austin and Ramsay (n 120) par [14.065]. On implied authority attached to specific company positions, see Austin and Ramsay (n 120) pars [13.070] – [13.110]. On corporate authority generally, see Chappel and Lipton *Corporate Authority and Dealings with Officers and Agents* (2002).

[132] s 198A(1).

meeting.[133] The powers of the board of directors may be delegated to any other person.[134]

Dealings with third parties are for the most part facilitated through the provisions of sections 128 – 129.[135] A person is entitled to make the assumptions set out in section 129 when dealing with the company. The company in any proceedings may not dispute these assumptions.[136] The assumptions apply even if the officer or agent of the company acted fraudulently, or forged a document in connection with the dealings.[137]

The only exception is if the third party knew or suspected[138] that the assumption was incorrect.[139] This knowledge or suspicion must be actual – it is not the objective enquiry of whether a reasonable person would, or ought to have, known or suspected in the circumstances that the assumptions were not met.[140] The statutory provision therefore differs from the common law *Turquand* rule in this respect.[141] That being said, Austin and Ramsay is of the opinion that the objective test of knowledge may assist the court in coming to a finding that the person in the particular circumstances actually knew that the assumptions were not met.[142] The knowledge and experience of the particular person may play a role in coming to the inference that she knew or suspected that the assumption had not been met. In the context of liability for knowing participation in breach of fiduciary duty, it has been

[133] s 198A(2). See also Austin and Ramsay (n 120) par [13.060].

[134] s 198D.

[135] The common law indoor management rule, or *Turquand* rule, remains available (*Australian Capital Television Pty Ltd v Minister for Transport and Communications* (1989) 86 ALR 119); Chappel and Lipton (n 131) 40 – 42. See in general Austin and Ramsay (n 120) pars [13.150] – [13.270], [13.340] and [13.421]. On the statutory provisions generally, see Austin and Ramsay (n 120) pars [13.280] – [13.300]; Simmons (n 120) par [2.3.0015].

[136] s 128(1).

[137] s 128(2) and Austin and Ramsay (n 120) par [14.110].

[138] Austin and Ramsay (n 120) par [13.300] states the test for suspicion in the following terms: "… a person will be found to have suspected only when it can be seen, usually by inference, that the person had formed a positive opinion, however weak, that there was something irregular about the appointment or the scope of authority." Simmons (n 120) par [2.3.0015] puts it in the following terms: "… at least an actual apprehension or mistrust amounting to a slight opinion that the fact exists." See also *Errichetti Holdings Pty Ltd v Western Plaza Hotel Corp Pty Ltd* (2006) 201 FLR 192 at [74], approving *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266.

[139] s 128(4).

[140] See Austin and Ramsay (n 120) par [13.300] and Simmons (n 120) par [2.3.0015].

[141] See Austin and Ramsay (n 120) par [13.340] for more about the differences between these provisions and common law indoor management rule.

[142] Austin and Ramsay (n 120) par [13.300].

held that a *wilful* omission to enquire, for fear of finding out about the breach of duty, amounted to actual knowledge.[143] Austin and Ramsay speculate that this might also hold true in the context of section 128(4).[144] The burden of proof is on the company to show that the third party had the necessary knowledge or suspicion.[145]

The first assumption is that the company's constitution and any provisions of the Act that apply to the company as replaceable rules have been complied with.[146] Replaceable rules are provisions of the Act that are indicated as such in the headings of the individual sections,[147] which may be amended in a company's constitution.[148] The non-compliance of a replaceable rule as it applies to a specific company is not considered a contravention of the Act.[149] Rather these rules have effect as a contract, similarly to the nature of a company's constitution.[150] Essentially this assumption entails that the company may not assert failures of internal management against third parties.

The second assumption is that a person indicated as a director or a company secretary by information provided by the company to the Australian Securities and Investment Commission ("ASIC") has been duly appointed and has the authority to exercise the powers and perform the duties customarily exercised or performed by a director or company secretary in a similar company.[151] A person may further assume that a person held out by the company to be an officer or an agent has been duly appointed as such, and has authority to exercise the powers and perform the duties of that kind of officer or agent of a similar company.[152]

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143 *United States Surgical Corporation v Hospital Products International Pty Ltd* [1983] 2 NSWLR 157 at 253F – 254B, referring to *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373 at 412.

144 Austin and Ramsay (n 120) par [13.300].

145 *Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279; Austin and Ramsay (n 120) par [13.300]; Chappel and Lipton (n 131) 45 – 49 show that Australian courts have interpreted these requirements more in line with the common law, restricting the availability of the protection afforded to third parties.

146 s 129(1).

147 s 135(1). A table of replaceable rules also appear in s 141. On the replaceable rules generally, see Hambrook (n 128) par [2.4.0015].

148 s 135(2).

149 s 135(3).

150 s 140(1). The contract is binding between the company and its members, the company and its directors, and between the members inter se.

151 s 129(2). See Austin and Ramsay (n 120) par [13.390] for a discussion of the extent of such authority.

152 s 129(3). See further Austin and Ramsay (n 120) par [13.410].

Further assumptions are that a person may rely on the proper performance of duties of officers and agents of a company,[153] and may rely on the proper execution of documents on behalf of the company if they appear to have been signed in accordance with section 127(1),[154] or if the company's common seal appears to have been fixed to the document in the proper manner.[155]

Similarly to the other jurisdictions surveyed, a person is not deemed to have information about a company merely because the information is available to the public from ASIC.[156] The doctrine of constructive notice has therefore been abolished for purposes of the constitutive documents of the company.[157]

Provisions of a company's constitution may be entrenched by inserting an additional requirement to the special resolution usually required for an amendment of a clause of the constitution.[158] The amendment of the provisions entrenching the clause may itself only be amended or removed by complying with the additional requirement set in that clause.[159] The constitution may provide for a different method of amendment.[160] However, it is not possible to entirely exclude the amendment of a clause of the constitution.[161]

4 *Observations from comparative perspectives*

When compared to the South African exceptions created for RF companies, the following observations may be made when considering the comparative perspectives discussed above:

4.1 Constructive notice of RF provisions

All of the surveyed jurisdictions have abolished constructive notice of any content of company documents simply because they have been lodged with a registrar or

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153 s 129(4). See further Austin and Ramsay (n 120) par [13.424]. This applies to the performance of fiduciary duties. See Austin and Ramsay (n 120) par [13.430].

154 s 129(5).

155 s 129(6).

156 s 130.

157 See also Austin and Ramsay (n 120) par [13.150] fn 3. Only constructive notice of registrable charges has been retained in the Act, s 130.

158 s 136(3). See further *Hillig v Darkinjung* (2006) 57 ACSR 733; 201 FLR 148 at [34]; Hambrook (n 128) par [2.4.0090].

159 s 136(4).

160 s 136(7).

161 Hambrook (n 128) par [2.4.0095]. See also *Medical Research & Compensation Foundation v Amaca Pty Ltd* (2004) 51 ACSR 587; [2004] NSWSC 1227 at [9]; *Peters' American Delicacy Co Ltd v Heath* ([1939] HCA 2; 1939) 61 CLR 457 at 479-480, 502-3.

similar body, or kept at the offices of the company. This strokes with the commercial reality that third parties dealing with trading companies rarely consult constitutive documents when dealing with the company.

"Third party" in this context typically refers to ordinary clientele and suppliers, rather than sophisticated persons, such as large lenders. The latter group of third parties often makes further enquiries as to ascertain actual authority of the persons they deal with, especially when large amounts are at stake.

The exception created by the South African RF provisions, namely that it provides constructive notice of the content of the RF clauses, applies to all third parties dealing with that company, regardless of their sophistication or the size of the transaction. As explained above, the RF provisions are phrased in wide terms and are peremptory, which means that many more companies than special purpose companies will fall under that category of company.

It is doubtful whether unsophisticated third parties dealing with companies in South Africa will know what the "RF" expression at the end of the company name means or what the implications are when dealing with these companies. In fact, partly owing to the confusing Practice Notice issued by the CIPC on the matter, many South African companies that ought to use the "RF" expression in their company names probably do not do so presently. The wording of section 19(5)(*a*), which sets out that a person must be regarded as having notice and knowledge of restrictive conditions or prohibitions of amendment as they relate to the RF provisions, makes it clear that such constructive notice only follows when the company makes use of the "RF" expression at the end of the company name. In absence of the use of the expression, the normal provisions regarding dealings with third parties will apply. There will be no constructive notice of the RF provisions and the company and its stakeholders will not be protected. Instead, dealings with third parties are immune from any limitations in the constitutive documents regarding capacity or authority.

In terms of section 20(6) of the Act, shareholders will be able to claim damages from any person who caused the company to act contrary to a limitation in capacity or powers, or who acted contrary to a limitation in authority. Additionally, a person who contravenes any provision of the Act is liable to any other person who suffered damages, costs or loss as a result of that contravention.[162] The only persons who may be said to contravene a provision of the Act by not complying with a restriction in capacity or powers, or by ignoring a limitation in authority, are the

[162] s 218(2).

directors of the company.[163] Prejudiced persons will therefore have recourse against the directors, and possibly others, who caused the company to act contrary to the provisions in the MOI. This is so regardless of the absence or the use of the “RF” expression at the end of the company name and even if constructive notice does not apply.

The only persons who stand to be prejudiced by dealing with RF companies who use the expression at the end of their company names, will be those not sophisticated enough to make further enquiries. Sophisticated third parties will draw the proper inference from the expression and make the proper enquiries. However, they would probably have done so without the inclusion of the “RF” expression as well.

It therefore follows that South African commerce stands very little to benefit from the exception to the abolition of constructive notice created for purposes of RF companies.

4.2 The role of good faith and knowledge

I explained above how the inclusion of constructive notice of the RF clauses may lead to an inability to claim good faith when dealing with the company contrary to any limitations in capacity or powers, or contrary to limitations in authority.[164] This has two consequences for the third party dealing with the company. First, she may not be able to claim damages if a shareholder, director or prescribed officer of the company restrained the company from the contravening actions. If the RF clause provided for a limitation in capacity, this would mean that the contract is not void, but unenforceable. Secondly, she will not be able to rely on section 20(7) of the Act, which states that she may presume that all the formal and procedural requirements of the MOI and of the Act have been complied with. Use of section 20(7) is further excluded if the third party reasonably ought to have known of the company’s failure to comply with a formal or procedural requirement of the MOI or of the Act. The constructive notice provided by the “RF” expression may, depending on the content of the clause to which it refers, trigger the responsibility to make further enquiries.

The only conceivable importance that the retention constructive notice for RF companies could have, is to influence the interpretation of whether a third party dealt

[163] ss 77(2)(*b*)(iii), 77(3)(*a*) and 77(3)(*c*). These sections provide for liability towards the company, but imply a duty owed to the company to adhere to the limitations in the memorandum of incorporation. I am therefore of the opinion that a failure to fulfil this duty will also constitute a contravention of the Act for purposes of s 218(2).

[164] See [2.2] above.

with the company in good faith. There has been no precedent considering the term in the context of the new South African Companies Act, which means that a court could possibly consider the subjective position of the third party when deciding whether she was acting in good faith, regardless of constructive notice. This could include the third party's educational background, language, and experience. However, there is a very real possibility that such an approach will leave the applicability of constructive notice, and therefore the statutory provision, without any purpose.

All of the jurisdictions surveyed make provision for a potential limitation of objects of a company, but such limitations alone may not lead to the invalidity of actions taken by the company. This is the case regardless of the knowledge of the third party of the limitation. Restraining action in the United Kingdom may only be taken before valid obligations come about. This means that even if a third party enters into a contract knowing that it is in contravention of a limitation of capacity the contract will remain enforceable. In New Zealand, restraining action may be taken after an obligation has been formed. The court has the power to grant consequential relief in that case.

In the United Kingdom Companies Act provides expressly that a person is not regarded as having acted in bad faith simply because she had knowledge that an action falls outside the powers of the directors, and that the third party is presumed to have acted in good faith. The precise interpretation of these provisions has not been settled, although it seems clear that dishonesty at a minimum would point towards bad faith. At least one South African author has tried to temper the interpretation of the South African provisions with a reference to the position in the United Kingdom.[165] However, this is misplaced, since the United Kingdom Act expressly excludes knowledge of the contents of the articles from pointing to bad faith. There is no similar provision in the South African Act. Instead, the South African statute retains a remnant of constructive notice.

The retention of the good faith requirement in section 20(5) might serve the purpose to exclude reliance by persons who wilfully neglect to make enquiries about possible limitations in the constitutive documents of the company, when circumstances are such that a reasonable person *in the position of that third party* would be alert to the possibility of such limitations. It should then be easier to show

[165] See Cassim "The Companies Act 2008: An Overview of a Few of its Core Provisions" 2010 *SA Merc LJ* 157 at 172.

that sophisticated third parties acted in bad faith.[166] However, this will only make sense if constructive notice was not given of the RF clauses.

Section 20(7) of the South African Companies Act may have been an attempt to emulate, but not replicate, section 18 of the Canada Business Corporations Act. The New Zealand Companies Act also contains a similar provision. A glaring difference between the provisions in the South African and New Zealand Acts and the Canadian Act, section 18 is that the latter only applies to limitations contained in the company's constitution, by-laws or agreed by unanimous shareholder agreement. It does not apply to requirements set in the Act. Actual knowledge of a restriction of authority, or if the third party ought to have known about the restriction owing to her relationship with the company, will exclude the relief provided to the third party in both the Canadian and New Zealand provisions. Good faith is not used as measure, and constructive knowledge is completely abolished. In line with the provisions in Canada and in New Zealand, I would favour the removal of good faith as a requirement in section 20(7) of the South African Act. In my opinion, the exception of actual knowledge, as well as when the person's relationship with the company ought to lead to actual knowledge, should have been the exceptions included in section 20(7).

4.3 Entrenchment of clauses

The South African RF provisions become relevant even if there is no restrictive condition, but only a prohibition to amend a particular clause in the MOI. The objective with this provision is clear enough – if a clause of the MOI is so important that it may not be amended, third parties must take constructive notice of that clause.

This approach seems to be out of step with that of the surveyed jurisdictions. While all of the surveyed jurisdictions allows for special majorities to amend certain clauses of the constitutive documents, none of them make provision for the complete prohibition of amendment of a clause of the constitutive document. Amendment remains available even if only with unanimous assent. None of the jurisdictions lend constructive notice of the entrenched clauses. In each case the regulator is charged with keeping record of the entrenched clauses and their amendment.

The constructive notice given to the entrenched clauses in the South African Act must be notice of the content of the clauses so entrenched and not of whether there has been compliance with the entrenchment itself. Any other interpretation will

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[166] Section 20(5) is not clear about the burden of proof. I am of the opinion that the burden of proof will be on the company to show that the third party acted in bad faith or with actual knowledge.

make no sense. If alteration of the clause is prohibited, a third party making the effort to make further enquiries will not be able to ascertain from the CIPC whether there has been adherence with the requirement – no filing is required for the alteration of a clause that may not be amended. The notice of incorporation or notice of amendment of the MOI must draw pertinent attention to any such clauses, which means that the CIPC does have a record of the existence of such clauses. If the clause excludes authority of particular persons to enter into specified agreements on behalf of the company, the third party will be deemed to be aware of such an exclusion of authority.

It seems that South Africa has decided to take its company law back to ancient beginnings when it comes to third party dealings in this context. Contrary to the other jurisdictions, where third parties may assume that the persons they deal with have authority to do so if it is usual or implied in the office of the person concerned, third parties in South Africa are taken back to the full application of the doctrine of constructive notice when they deal with RF companies. The company will not be bound to such a transaction, unless it is ratified.

If the alteration of the clause is subject to a special majority, or another requirement in addition to a special resolution of the shareholders, the adherence to this requirement too will not be ascertainable from the CIPC. Constructive notice of the requirement for amendment will therefore lead to a possible reliance on the common law *Turquand* rule, as its compliance is not ascertainable from the public documents. A blanket exclusion of authority may then not prove enough for the company to escape liability. The company will have to prove that the third party actually suspected that the clause was not amended in the prescribed manner.

In the end, the retention of constructive notice for these clauses does not fit in with the larger scheme of the Act, which aims to facilitate third party dealing rather than to restrict it.

5 *Conclusion*

The legislative decision was taken in all the surveyed jurisdictions to place the risk of non-compliance with limitations in capacity, powers and authority on the shareholders of the company rather than third parties. In absence of dishonesty or fraud by the third party, the approach is to allow third parties to assume in the widest possible sense that the company's capacity is that of an individual. Similarly, the third party may assume that usual and implied authority is unrestricted.

The South African Companies Act incorporates all of these characteristics for companies other than RF companies. If the RF provisions were simply removed the

Act would be no poorer for it. Shareholders of special purpose companies will still have the power to restrain the company from entering into transactions outside the limitations contained in the MOI. They will retain the remedy of damages against any person who intentionally, fraudulently or due to gross negligence caused the company to act contrary to the limitations in capacity and authority. Such companies will be no worse off than they were under the Companies Act 61 of 1973, but third parties will have the assurance that they could transact with any type of profit company in South Africa without the need to engage with voluminous constitutive documents.

The removal of the RF provisions and with it the exception to the abolition to constructive notice will mean that the good faith requirement in section 20(5) may be ascribed a more subjective interpretation, namely whether the circumstances were such that a reasonable person *in the position of that third party* would be alert to the possibility of such limitations, but that the person wilfully neglected to make further enquiries. This will lend the flexibility to expect more of a sophisticated third party, who may be expected to understand the nature of the company it is dealing with. At the same time it will be harder to show bad faith if the third party is an inexperienced or uneducated person.

The South African Companies Act goes further than the comparable statutes in the surveyed jurisdictions in allowing for the complete prohibition of amendment of certain clauses of its MOI. Allowing for the prohibition of amendment of clauses is not in itself a problem – although strong arguments may be made to allow for flexibility of the content of the MOI in all cases. Lending constructive notice to these clauses may, however, bring South Africa back to a complete application of the doctrine of constructive notice. Constructive notice of entrenched provisions will also lead to the continued relevance of the common law *Turquand* rule, depending on the content of the clause. This is out of step with the international approach, as well as with the general internal structure of the Companies Act as a whole.

It is therefore my view that South Africa should remove the RF provisions from its statute in favour of a complete abolition of constructive notice.

Current developments in European capital markets law – MiFID II and PRIIP

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I. Introduction: European capital markets law

1. FSAP and the financial crisis

Since the 2008 financial crisis, legislators across the world have tightened up rules for banks, insurance companies and other capital market participants, including in the USA[1], the United Kingdom[2] and in South Africa.[3]

European capital markets law was originally derived from the Segré report in 1966[4], but current European rules are based on the Financial Services Action Plan (FSAP) from 1999.[5] Most of today's directives and regulations are based on the FSAP, including the Prospectus Directive[6], MiFID I[7], the Market Abuse Directive[8], the Transparency Directive[9], and the Takeover Directive[10].

A special legislative procedure to implement the FSAP was proposed by a Committee of Wise Men headed by Baron von Lamfalussy – the Lamfalussy Process. It comprised three

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 21.7.2010, 124 Stat. 1376 (2010).

2 Financial Services Act 2012, An Act to amend the Bank of England Act 1998, the Financial Services and Markets Act 2000 and the Banking Act 2009; to make other provision about financial services and markets; to make provision about the exercise of certain statutory functions relating to building societies, friendly societies and other mutual societies; to amend section 785 of the Companies Act 2006; to make provision enabling the Director of Savings to provide services to other public bodies; and for connected purposes, 19.12.2012, 2012 c. 21.

3 *Implementing a twin peaks model of financial regulation in South Africa*, 1.2.2013, available at: <http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%203%20Roadmap.pdf>.

4 EEC Commission, *The development of a European capital market*: Report of a Group of Experts appointed by the EEC Commission, 1966.

5 Commission communication on implementing the framework for financial markets: Action Plan, 11.5.1999, COM (1999), 232 final.

6 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, pp. 64 – 89 (Prospectus Directive).

7 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and Directive of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, pp. 1 - 44 (MiFID I).

8 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ L. 96, 12.4.2003, pp. 16-25 (Market Abuse Directive).

9 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004, pp. 38-57 (Transparency Directive).

10 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, pp.12–23 (Takeover Directive).

legislative levels and a regulatory level, thus totalling four levels.[11] This approach resulted in a rush of framework directives, implementation directives and guidelines from the European regulatory body, the CESR (Committee of European Securities Regulators).[12]

The 2008 financial crisis led to reform of the European regulatory structures and more than thirty individual measures in the area of banking, capital markets and insurance law, as proposed by the *de Larosière* Group.[13] The European regulatory authorities are now ESMA (European Securities and Markets Authority) for the securities sector (institutional successor to the CESR), the EBA (European Banking Agency) for the banking sector, and EIOPA (European Insurance and Occupational Pensions Agency) for the insurance sector. The Lamfalussy process was also revised, and the directives listed above were revised and strengthened. Under the reformed Lamfalussy Process (so called Lamfalussy II Process),[14] at the first level the European Commission, Council and Parliament adopt framework legislative acts, such as directives or regulations. These are then substantiated at the second level by delegated acts (Article 290 Treaty on the Functioning of the European Union, TFEU) and implementing acts (Article 291 TFEU) from the Commission. The European regulatory authorities may also issue regulatory technical (RTS) or implementation technical standards (ITS) if this is envisaged by the framework act. At the third level, the regulatory authorities issue guidelines and recommendations.[15] They have the status of secondary legislation and a more than de facto binding effect, since they create a presumption of correctness and the Member State must state and explain why it does not intend to follow the prescription of such guidelines.[16]

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[11] On the Lamfalussy Process, see *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, 15.2.2001, available at: <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf>.

[12] See *K. Langenbucher*, Zur Zulässigkeit parlamentsersetzender Normgebungsverfahren im Europarecht, ZEuP 2002, 265 ff.; *T. Möllers*, Europäische Methoden- und Gesetzgebungslehre im Kapitalmarktrecht, ZEuP 2008, 480 ff.; *K. Schmolke*, Der Lamfalussy-Prozess im Europäischen Kapitalmarktrecht - eine Zwischenbilanz, NZG 2005, 912 ff.

[13] *De Larosière*, The High-Level Group on Financial Supervision in the EU, Report, 25.2.2009.

[14] Academic texts sometimes refer to the Lamfalussy II Process, see *M. Lutter/W. Bayer/J. Schmidt*, Europäisches Unternehmens- und Kapitalmarktrecht, 5th Edn. 2012, § 17 marginal note 47; *F. Walla*, Die Europäische Wertpapier- und Marktaufsichtsbehörde (ESMA) als Akteur bei der Regulierung der Kapitalmärkte Europas – Grundlagen, erste Erfahrungen und Ausblick, BKR 2012, 265, 267; *L. Klöhn*, in: K. Langenbucher, Europäisches Privat- und Wirtschaftsrecht, 3rd Edn. 2013, § 6 marginal note 20.

[15] ESMA Framework Regulation (EU) Nr. 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ. L 331, pp. 84–119 (ESMA Regulation).

[16] *T. Möllers*, Auf dem Weg zu einer neuen europäischen Finanzmarktaufsichtsstruktur - Ein systematischer Vergleich der Rating-VO (EG) Nr. 1060/2009 mit der geplanten ESMA-VO, NZG 2010, 285, 286; followed in BVerwG, judgment of 24.5.2011, Az. 7 C 6/10, ZIP 2011, 1313 marginal note 26.

The Prospectus Directive [17] and Prospectus Regulation[18], the Market Abuse Regulation[19], the Market Abuse Directive[20], the Transparency Directive[21] and MiFID were revised. In order to close gaps, the UCITS Directives IV[22] and V[23], the AIFM Directive[24], the Short-selling Regulation[25], EMiR[26] and the Rating Regulation[27] were passed.

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17 Prospectus Directive (fn. 6), last amended by Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014, OJ L 153, 22.5.2014, pp. 1–61 (Omnibus II). The Prospectus Directive is currently being revised; see the Consultation on the Review of the Prospectus Directive, 18.2.2015, available at: <http://ec.europa.eu/finance/consultations/2015/prospectus-directive/index_en.htm>.

18 Commission Regulation (EU) No. 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website, OJ. L 176, 10.7.2010, pp. 1–15.

19 Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, OJ L 173, 12.6.2014, pp. 1–61.

20 Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (Market Abuse Directive), OJ L 173, 12.6.2014, pp. 179–189.

21 Transparency Directive (fn. 9), last amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013, OJ L 294, 6.11.2013, pp. 13–27.

22 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, pp. 32–96 (UCITS IV).

23 Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, OJ L 257, 28.8.2014, pp. 186–213 (UCITS V).

24 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, pp. 1-73 (AIFM Directive).

25 Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, OJ L 86, 24.3.2012, pp. 1-24. (Short-selling Regulation).

26 Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 27.7.2012, pp. 1-59 (EMiR).

27 Regulation (EG) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, OJ L 302,17.11.2009, pp. 1–31 (Rating Regulation); amended by Regulation (EU) No. 513/2011 of the European Parliament and of the Council of 15 May 2011 amending Regulation (EC) No. 1060/2009 on credit rating agencies, OJ L 145, 31.5.2011, pp. 30-56 and Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013, OJ L 146, 31.5.2013, pp. 1-33; see *T. Möllers/C. Niedorf*, Regulation and Liability of Credit Rating Agencies, 11 ECFR 333, 346 (2014).

2. Rules governing financial instruments - MiFID II

Securities law was harmonised by the Securities Investment Services Directive.[28] This was then replaced in 2004 by the Markets in Financial Instruments Directive (MiFID I)[29] and its many implementation provisions.[30]

After publication of a draft Proposal[31], which was then amended by the Parliament[32], the second Markets in Financial Instruments Directive (MiFID II) was passed on 16 April 2014.[33] It is supplemented by the Markets in Financial Instruments Regulation (MiFIR).[34] The provisions of both are applicable in Member States as of 3 January 2017.[35]

The European Securities and Markets Authority (ESMA) also adopts rules and regulations. An ESMA consultation paper from 22 May 2014[36] proposed technical regulatory and implementation standards as from 19 December 2014 that must be implemented by the middle of May 2015.[37]

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28 Council Directive 93/22/EEC of 10 Mai 1993 on investment services in the securities field, OJ L 141, 11.6.1993, pp. 27–46 (Securities Investment Services Directive).

29 See above, fn. 7.

30 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241, 2.9.2009, pp. 26-58; and Commission Regulation (EC) Nr. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive, OJ L 241, 2.9.2006, pp. 1–25.

31 European Commission, Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council of 20.01.2011, COM(2011) 656 final.

32 Amendments of the European Parliament on 26 October 2012 on the proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast), P7_TA-PROV(2012), 0406.

33 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, pp. 349-496 (MiFID II); *M. Weber*, Die Entwicklung des Kapitalmarktrechts im ersten Halbjahr 2014, NJW 2014, 2327, 2328.

34 Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, OJ L 173, 12.6.2014, pp. 84-148. (MiFIR).

35 See Art. 93 (1)(1) MiFID II (fn. 33).

36 Consultation Paper on MiFID II/MiFIR of 22 May 2014, ESMA/2014/549, available at: <http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf>.

37 Consultation Paper MiFID II/MiFIR of 19 December 2014, ESMA/2014/1570, available at: <http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii.pdf>.

3. Evaluation

The level of activism at European and national levels is impressive. The attempt to make European law more effective, by making ESMA much more effective at a European level than the CESR, is also significant.

It should also be noted that European and national banking and capital markets laws are becoming increasingly overwhelming for those who have to apply the laws. In the past, this was due to the *speed* at which laws were issued, with revisions appearing or new provisions being passed several times a year – "law in permanence".[38] Capital markets laws have already overshadowed German tax laws, which generated a certain amount of horror worldwide. Secondly, capital markets law is now so *complicated* because the Lamfalussy Process means that rules are being created and substantiated at three European levels and at three national levels.[39] There is talk of "hyperactive legislatures"[40] and a "tsunami of regulations".[41] This legislative activism is having an impact on legal certainty, as many provisions have only a short "life cycle" and it is difficult for cases to be decided on the basis of these provisions. All of this is so confusing that it needs to be structured, such as via a databank on capital markets law.[42]

An intensive creation of regulations is designed to avoid a race to the bottom both for the private market participants and the regulatory authorities. The stated aim is to achieve a harmonised law (level playing field),[43] thus reducing phenomena such as gold plating or cherry picking,[44] and also transaction costs across various markets.[45] But will these aims be fulfilled?

The complexity comes from the necessary standardisation of *European and national laws.* Do we need to reduce their complexity? Four points are discussed below. Firstly, over

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38 *G. Spindler*, Kapitalmarktreform in Permanenz - Das Anlegerschutzverbesserungsgesetz, NJW 2004, 3449 ff.; *H. Hirte/T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, preface.

39 Laws, regulations and guidelines of the BaFin, see *R. Veil*, in: R. Veil, Europäisches Kapitalmarktrecht, 2nd Edn. 2014, § 5 marginal note. 13 ff.

40 *H.-D. Assmann/U. Schneider*, in: H.-D. Assmann/U. Schneider (Publ.), WpHG, 4th Edn. 2006, preface.

41 *P. Mülbert*, Regulierungstsunami im europäischen Kapitalmarktrecht, ZHR 186 (2012), 369 ff.

42 See the author's databank on European economic law that receives one and a half million hits each year, available at: <www.kapitalmarktrecht-im-internet.eu>.

43 See *K. Hopt/H.-C. Voigt*, Prospekt- und Kapitalmarktinformationshaftung, 2005, p. 2 ff.

44 Reporter *Edgardo Maria Iozia* in statement of the European Economic and Social Committee on the "Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products", 14./15.11.2012, COM(2012) 352 final - 2012/0169 (COD) (2013/C 11/13) under 3.4.

45 *De Larosière* (fn. 13), marginal note 101; *H. Fleischer/K. Schmolke*, Die Reform der Transparenzrichtlinie: Mindest- oder Vollharmonisierung der kapitalmarktrechtlichen Beteiligungspublizität?, NZG 2010, 1241, 1245 f.

the past thirty years, harmonisation of legislation in the private law field has been characterised by the principle of minimum harmonisation, which allows Member States discretion to pass or keep stricter national provisions in favour of consumers or investors. Directives were the form of regulatory instruments often chosen, as they leave it to the discretion of Member States as to how they wish to implement the codification under European law. There has now been some change in this area. There is also a quite clear shift from minimum harmonisation towards the idea of maximum harmonisation.[46] Secondly, there is a lack of clarity about when the European legislature will choose the form of a directive, and when it will choose the form of a regulation. Thirdly, there is a lack of clarity about national legislatures pressing ahead with changes, which forces the Member State to amend the national laws passed prior to the European law as soon as the European law comes into force. And, lastly, the extent of non-harmonised areas of law is unclear – including parts of national civil law. Do the European legal norms only apply with respect to public law, or also to civil law?

These four doctrinal legal questions should be looked at in the context of the three current areas of regulation under MiFID II. These are the issue of information, particularly the Key Information Sheet (section II) and dealing with conflicts of interest for commission-based advice in comparison with the newly introduced fee-based advice (section III). Questions concerning enforcement of the law are addressed in conjunction with the individual issues, and subsequently considered in terms of liability under civil law (section IV).

II. Information obligations during information session: Key Information and the Key Information Document

1. Providing comprehensive standardised information, and information overload

One positive aspect for investors is that under the Securities Investment Services Directive, before giving investment advice investment firms were required to intensively look into the wishes and financial situation of the investor (“know your customer”). It also introduced the principle that investment firms needed to know about the product they were selling (“know your product”).[47]

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[46] *T. Möllers*, Vollharmonisierung im Kapitalmarktrecht - Zur Regelungskompetenz nationaler Gerichte und Parlamente, in: B. Gsell/C. Herresthal (Publ.), Vollharmonisierung im Privatrecht, Die Konzeption der Richtlinie am Scheideweg?, 2009, p. 247 ff.; *C. Gerner-Beuerle*, United in diversity: maximum versus minimum harmonization in EU securities regulation, 7 CMLJ 317 ff. (2012).

[47] Applies to the “know your customer” and “know your product” principle derived from Art. 11 (1) (4) and (5) of the Securities Investment Services Directive (fn. 28) and also developed by the Federal Court of Justice (BGH), BGH, judgment of 6.7.1993, Az. XI ZR 12/93, BGHZ 123, 126, 128 ff. – Bond; see *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31 marginal note 338.

Giving information and advice are designed to allow the investor to make a rational decision about the investment. This can be found in the wording of MiFID II[48] and Section 31 (3) sentence 1 of the Securities Trading Act (WpHG).[49]

After the Securities Investment Services Directive was adopted, there was debate about whether investment firms could fulfil their information obligations (Section 31 (2) (2) WpHG old version) by providing abstract, standardised information, or whether in each case they were required to provide substantive, customised information. The Federal Financial Supervisory Authority (BaFin) stated that the provision of standardised information was permissible,[50] but some academic authors said that general[51] individualised information[52] was required. After the implementation of MiFID I,[53] provision of standardised information was permissible for information purposes (Section 31 (3) sentence 2 of the Securities Trading Act (WpHG)). Customised information only had to be provided for investment advice.[54]

In Germany, it is normal for the key information for securities and other investments to run to about 170 pages.[55] The complexity of the key information seems to constitute an information overload for many investors.[56] The term "information overload" implies a cognitive threshold in excess of which no more information can be taken on or processed.[57] In practice, it is accepted that investors with below-average abilities to understand the products

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48 Art. 24 (5) sentence 1 MiFID II (fn. 33): "so that clients… are reasonably able… to take investment decisions on an informed basis." Previously, see Art. 19 (3) MiFID I (fn. 7).

49 Section 31 (3) sentence 1 WpHG (translated from German): "…and to take investment decisions on this basis"; see *T. Möllers/M. Poppele*, Paradigmenwechsel durch MiFID II: divergierende Anlegerleitbilder und neue Instrumentarien wie Qualitätskontrolle und Verbote, ZGR 2013, 437, 448, 465.

50 B.2.2. of the directive pursuant to § 35 (6) oft he Securities Trading Act (WpHG) to substantiate §§ 31 and 32 WpHG für das Kommissionsgeschäft, den Eigenhandel für andere und das Vermittlungsgeschäft der Wertpapierdienstleistungsunternehmen, 23.8.2001, BAnz. Nr. 165 of 4.9.2001, p. 19217.

51 Regardless of the type of business, compare *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 132.

52 Against permissibility, see *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 3rd Edn. 2003, § 31 marginal note 96a, 104; *F. Leisch*, Informationspflichten nach § 31 WpHG, 2004, p. 133 f; *T. Möllers/T. Ganten*, Die Wohlverhaltensrichtlinie des BAWe im Lichte der neuen Fassung des WpHG – Eine kritische Bestandsaufnahme, ZGR 1998, 773, 785 ff.

53 Art. 19 (3) sentence 2 MiFID I (fn. 7).

54 See under section III.1.; *A. Fuchs*, WpHG, 2009, § 31 marginal note 242, 250.

55 Compare *Basisinformationen über Wertpapiere und weitere Kapitalanlagen*, 2014.

56 Applicable to *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 93c.

57 *J. Jacoby/D. Speller/C. Kohn-Berning*, Brand Choice Behavior as a Function of Information Load, 1 JcR 33 ff. (1974); *N. Malhotra*, Information Load and Consumer Decision Making, 8 JcR 419 ff. (1982); *H. Berndt*, Konsumentenentscheidung und Informationsüberlastung, 1983, p. 89; *H. Hagemann*, Wahrgenommene Informationsbelastung des Verbrauchers, 1988, p. 87.

will not be protected.[58] Yet these are exactly the investors who need to be protected and are in most urgent need of clear and understandable information.[59]

The EU legislature appears to be aware of this misplaced concept: MiFID II leaves the decision about whether to allow standardised information up to the discretion of the Member State.[60]

2. The German Product Information Sheet from 2011

The German legislature took a pioneering stance in Europe when in 2011 – pursuant to the newly introduced Section 31 (3a) of the Securities Trading Act (WpHG)[61] – it required investment services enterprises to give their clients a Product Information Sheet when they were providing investment advice.

Similar obligations concerning investor information can also be found outside the Securities Trading Act (WpHG) in the Capital Investment Act (VermAnlG) and the Investment Code (KAGB).[62] This Product Information Sheet is intended to summarise the main risks and opportunities of an investment product,[63] similar to the information leaflet included with

58 *K. Rothenhöfer*, in: E. Schwark/D. Zimmer, KMRK, 4th Edn. 2010, § 31 WpHG marginal note 112; also *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 66; *P. Buck-Heeb*, Verhaltenspflichten beim Vertrieb, ZHR 177 (2013), 310, 338.

59 *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 93c and refers for the deficits in general financial knowledge to *M. Habschick/J. Evers*, Anforderungen an Finanzvermittler – mehr Qualität, bessere Entscheidungen, Studie im Auftrag des BMELV, 2008, p. 17, 125; *D. Leuering/D. Zetzsche*, Die Reform des Schuldverschreibungs- und Anlageberatungsrechts – (Mehr) Verbraucherschutz im Finanzmarktrecht?, NJW 2009, 2856, 2861.

60 Art. 24 (5) sentence 2 MiFID II (fn. 33).

61 Introduced by Art. 1 (6) of the Investor Protection and Capital Markets Improvement Act, 5.4.2011, BGBl. I, p. 538 (AnsFuG). Substantiated by Section 5a of the Regulation Specifying Rules of Conduct and Organisational Requirements for Investment Services Enterprises (WpDVerOV), 20.7.2007, BGBl. I 2007, p. 1432; see *T. Möllers/T. Wenninger*, Das Anlegerschutz- und Funktionsverbesserungsgesetz, NJW 2011, 1697, 1698.

62 *T. Möllers*, NJW Editorial: Alleingang beim Anlegerschutz – das KAGB, NJW 2012, volume 52, I; *T. Möllers*, Das Haftungssystem nach dem KAGB, in: T. Möllers/A. Kloyer (Publ.), Kapitalanlagegesetzbuch, 2013, marginal note 639 ff.

63 On Section 31 (3a) WpHG *T. Möllers/T. Wenninger*, Das Anlegerschutz- und Funktionsverbesserungsgesetz, NJW 2011, 1697 f; *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31 marginal note 299 ff.

medicines packaging[64] or the product information sheets under insurance[65] and consumer credit law.[66]

To its credit, the German legislature has also sought to use the Product Information Sheet pursuant to Section 31 (3a) of the Securities Trading Act (WpHG) to counter information overload. However, the aim of improving information efficiency is lost if the information sheets are handed over with a flood of other information, such as the product prospectus, and thus get swamped in a sea of paper.[67] There was also criticism that the Product Information Sheet does not permit the desired level of comparability between products.[68]

3. Key Information Documents for packaged financial products under the European PRIIP Regulation

a) Scope and content

The European legislature had already required UCITS fund managers to provide “key” information for investors in a form that was less voluminous and complex (Key Investor Information Document –KIID).[69] Before the German Product Information Sheets were introduced, it was already clear that the European legislature planned to transfer the KIID concept to all packaged retail investment products (PRIPs).[70] In July 2012, the Commission presented a set of measures that included a Proposal for a Regulation on key information documents for investment products (Key Information Documents Regulation).[71] This was now

64 Section 11 of the Medicines Products Act (AMG); see *K. Nink/H. Schröder*, Zu Risiken und Nebenwirkungen: Lesen Sie die Packungsbeilage?, PharmR 2006, 118.

65 Information required pursuant to Section 7 (1) sentence 1 of the Insurance Contract Act (VVG) in conjunction with Section 1 (1) of the Regulation on Information Obligations concerning Insurance Contracts (VVG-InfoV) must be presented in a summarised form in a Product Information Sheet – see Section 4 VVG-InfoV.

66 Section 491a (1) of the Civil Code (BGB), Art. 247 (2) Introductory Act to the Civil Code (EGBGB).

67 *B. Müller-Christmann*, Das Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarktes, DB 2011, 749, 751; *J. Koch*, Grenzen des informationsbasierten Anlegerschutzes - Die Gratwanderung zwischen angemessener Aufklärung und information overload, BKR 2012, 485, 487.

68 Federation of German Consumer Organisations (VZBV), 14.6.2010, available at: <www.vzbv.de/sites/default/files/mediapics/produktinformationsblaetter_untersuchung_14_06_2010.pdf>.

69 Art. 78 UCITS IV (fn. 22).

70 See *Commission*, Update on Commission Work on Packaged Retail Investment Products, 16.12.2009, p. 3, available at: <http://ec.europa.eu/finance/finservices-retail/docs/investment_products/20091215_prips_en. pdf>.

71 See *Commission*, Press release dated 3.7.2012, IP/12/736; Proposal for a Regulation of the European Parliament and of the Council on key information documents for investment products, 3.7.2012, COM (2012), 352 final.

extended to packaged retail and insurance-based investment and products (PRIIP). The products are deemed packaged if the surrender values fluctuate due to dependence on reference values or to development of a combination of various assets in which the client does not have a direct holding.[72] The Regulation is aimed at product manufacturers (issuers) and sellers, ie. fund managers, insurance companies, credit institutions, or investment firms.[73]

Key Information Documents must summarise the product succinctly on three pages, ie. be formulated in a clear, precise and understandable language[74] and provide answers to many standard questions that might be asked.[75] The provisions are to be further substantiated by technical regulatory standards to be drawn up by European supervisory authorities during the course of 2015;[76] the Regulation comes into force on 31 December 2016.

b) Fines and prohibitions

Sanctions include "shaming" (Art. 29) and fines up to €5 million or 3% of annual turnover (Art. 24 (2)(e)). Finally, EIOPA (Art. 16 (1)) or the responsible national competent authority (Art. 17 (1)) may prohibit certain insurance-based investment products where these raise significant concerns about investor protection or constitute a threat to the orderly functioning and integrity of financial markets.

4. Evaluation

a) Differences between the German Product Information Sheet and the European Key Information Document

There are several points where the German Product Information Sheet pursuant to Section 31 (3a) of the Securities Trading Act (WpHG) differs from the PRIIP Regulation:

- The scope of application of the German Product Information Sheet is much wider than the Key Information Document, because it applies to all financial instruments, including equities. By contrast, the PRIIP Regulation applies only to packaged financial products, and expressly excludes equities and bonds from the scope of the obligation to provide a Key Information

72 See Recital 1 and Art. 4 of Regulation (EU) Nr. 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), OJ L 352, 9.12.2014, pp. 1–23 (PRIIP Regulation).

73 Recital 12 and Art. 5 (1) PRIIP Regulation (fn. 72).

74 Art. 6 (4) sentence 1 and (4) sentence 2 item (c) PRIIP Regulation (fn. 72).

75 Such as: How does risk arise? What costs will be incurred? How long should I hold the investment? How can I make a complaint? etc., see Art. 8 (3) (d) PRIIP Regulation (fn. 72).

76 Art. 8 (5) (3) and (10) (2) (2) PRIIP Regulation (fn. 72).

Document.[77] With equities, the investor invests directly in the financial product; equities are also not complex securities, because the main risk is the insolvency risk of the company. But the loss risks from structured products are not only much more complex and thus more difficult to understand; losses can even far exceed the purchase cost of the product. Derivatives or leveraged instruments can be acquired for a low purchase price, but they carry a loss risk that is not restricted to the initial purchase price invested (nominal value).[78] Adverse developments can generate a negative market value for these products that cannot be determined in advance.[79] In contrast to an investment in a simple equity, for which the maximum worst-case scenario is total loss of the capital invested, such investments can require the provision of supplementary liquidity.[80] Finally, the information asymmetry is much lower for equities than for complex financial products, as listed companies must regularly provide and publish comprehensive information for the capital markets.[81] In order to avoid over-regulation, the European approach seems to be more appropriate than the German solution.[82]

- On the other hand, Section 31 (3a) of the Securities Trading Act (WpHG) is formulated too narrowly, since the Product Information Sheet must be provided only for investment advice and then only for the recommended product. However, since the recommendation must often be limited to a single product,[83] the improved comparability between different products[84] promulgated by Section 31 (3a) of the Securities Trading Act (WpHG) only then applies if the customer inquires about other products and receives further information sheets.[85] In practice, this is an unrealistic scenario. Pursuant to Article 13 (1) of the PRIIP Regulation, the duty to provide the Key Information Document is incumbent on both the adviser and the seller. This wide application seems practical, as it permits investors to compare different products even if they are just seeking information and not advice.

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77 See Recital 7 and Art. 2 (d) PRIIP Regulation (fn. 72).

78 *S. Rudolf*, in: S. Kümpel/A. Wittig, Bank- und Kapitalmarktrecht, 4th Edn. 2011, marginal note. 19.56.

79 *S. Rudolf*, in: S. Kümpel/A. Wittig, Bank- und Kapitalmarktrecht, 4th Edn. 2011, marginal note 19.53; *J. Roberts*, Finanzderivate als Glücksspiel? Aufklärungspflichten des Emittenten, DStR 2010, 1082, 1083.

80 *J. Roberts*, Risikoangaben beim Verkauf von Derivaten, DStR 2014, 1116; *P. Melzer*, Zum Begriff des Finanztermingeschäfts, BKR 2003, 366, 369.

81 On publicity as needed and disclosure in secondary markets, see *T. Möllers*, in: T. Möllers/K. Rotter (Publ.), Ad-hoc-Publizität, 2003, § 2 marginal note 50.

82 See already *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31 marginal note 299.

83 *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 132.

84 Explanation, AnsFuG v. 8.10.2010, BT Printed papers 17/3628, p. 21.

85 *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 122.

- Finally, the German version is too narrow because a Product Information Sheet is only required when giving advice; the duty is incumbent on the seller of the financial service, whereas the PRIIP Regulation is mainly directed at the PRIIP manufacturer (or issuer).
- In contrast to the German Product Information Sheet, Article 8 of the PRIIP Regulation requires a standardised presentation of the Key Information Document.[86] As this supports comparison between different products, this requirement should be welcomed.[87]

b) The sense of national governments implementing changes ahead of others

The PRIIP Regulation follows a horizontal approach that applies in the same way to structured financial products and to financial products under MiFID II, such as options, UCITS, open-end investment funds and insurance products (such as unit-linked life insurance).

One might ask why the German legislature would introduce certain regulations in banking and capital markets law only a few months before the European legislature. The desire to export national provisions to the European level[88] does not seem really convincing, because the rules would not be in existence long enough to be adopted at the European level. Indeed, it was rather the reverse: the German legislature designed its approach around the European rules, which were in the draft stage. A more convincing argument is a sort of populism: the national legislature wanted to give the impression that it was reacting to the financial crisis and establishing rules to protect investors. In other words: the Bundestag does not just implement European law, but suggests to its citizens that it is independently creating legal solutions to respond to problems. This may be a clever political move, but it is less efficient from an economic perspective. It increases transaction costs for market participants, as within a short period they need to respond and adapt to different parameters.[89] Instead of pressing ahead with Section 31 (3a) of the Securities Trading Act (WpHG), the German legislature should have waited for the EU rules, which by that time had already been substantiated. As already demonstrated, the existing WpHG Product

[86] In contrast to Section 31 (3a) WpHG in conjunction with Section 5a WpDVerOV (fn. 61).

[87] For this type of criticism of Section 31 (3a) WpHG, see *J. Koch*, Grenzen des informationsbasierten Anlegerschutzes - Die Gratwanderung zwischen angemessener Aufklärung und information overload, BKR 2012, 485, 487 with further evidence.

[88] The Takeover Directive (fn. 10) provides a good example here. It is based on the City Code on Takeovers and Mergers (City Code) from London, see *H. Hirte/T. Heinrich*, in: H. Hirte/C. von Bülow (Publ.), Kölner Kommentar zum WpÜG, 2nd Edn. 2010, Intro. marginal note 72.

[89] For critical view, *Möllers/Wenniger,* Öffentliche Stellungnahme als Sachverständiger vor dem Bundestag zum Regierungsentwurf eines Gesetzes zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung, BT printed papers. 16/12814; for the Small Investor Protection Act (Kleinanlegerschutzgesetz) (fn. 193), see *T. Jesch/S. Siemko*, Das Kleinanlegerschutzgesetz - Verbraucherschutz, schneller als MiFID II erlaubt?, BB 2014, 2570.

Information Sheets do not comply with the provisions of the Key Information Documents promulgated by the Regulation.[90] As the Regulation is directly applicable, the German legislature needs to repeal the national provisions in the PRIIP area of applicability – namely provisions governing packaged products. This means it has effectively reduced German capital markets participants to guinea pigs, and caused high transaction costs.[91]

c) Overreaching law

It is possible that the German legislature could restrict German Product Information Sheets to those financial instruments that are not covered by PRIIP. This would be permissible, because the Regulation expressly allows[92] Member States to pass their own national rules for areas outside the scope of the Regulation – such as for simple equities.

d) Limits of information models

So far, only EIOPA or national competent authorities have been able to issue prohibitions and restrictions in the area of insurance investment products.[93] There is no legal basis which would allow ESMA or national competent authorities to issue similar substantive rules for traditional financial products.[94]

Finally, even EU information sheets cannot hide the fact that information-based investor protection has reached its "inherent limits".[95] Simplified information sheets might have their uses for simple structured products like investment fund units.[96] But the regulation concept does not work for complex products: If the risks of such products cannot be explained sufficiently even in extensive advisory sessions, as was made clear in the facts of

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90 See *J. Seitz/A. Juhnke/S. Seibold*, PIBs, KIIDs und nun KIDs – Vorschlag der Europäischen Kommission für eine Verordnung über Basisinformationsblätter für Anlageprodukte im Rahmen der PRIPs-Initiative, BKR 2013, 1 ,4, 7; also *P. Buck-Heeb*, Verhaltenspflichten beim Vertrieb, ZHR 177 (2013), 310, 316.

91 See evidence in fn. 89.

92 Recital 8 PRIIP regulation (fn. 72).

93 Compare Art. 16 (1) and Art. 17 (1) PRIIP Regulation (fn. 72).

94 The legal basis was still in the Proposal (fn. 71), but was then deleted. There is a reference to ESMA in Recital 25 of the PRIIP Regulation (fn. 72).

95 See *J. Koch*, Grenzen des informationsbasierten Anlegerschutzes - Die Gratwanderung zwischen angemessener Aufklärung und information overload, BKR 2012, 485 ff.; previously *J. Köndgen*, Grenzen des informationsbasierten Anlegerschutzes – also comment on BGH, judgment of 22.3.2011 Az. XI ZR 33/10, BKR 2011, 283 ff.; *idem,* Structured Products from the Perspective of Investor Protection: Can the Courts Police the Market or Do We Need More Regulation?, in: Festschrift K. Hopt, 2010, p. 2113, 2138 ff.

96 See *F. Podewils*, Beipackzettel für Finanzprodukte - Verbesserte Anlegerinformation durch Informationsblätter und Key Investor Information Documents?, ZBB 2011, 169 ff.; *J. Köndgen*, Grenzen des informationsbasierten Anlegerschutzes – also comment on BGH, judgment of 22. 3. 2011, Az. XI ZR 33/10, BKR 2011, 283, 285.

the *Zinswette* case,[97] then they certainly cannot be summarised effectively on three DIN-A4 pages[98].[99] It remains to be seen how far the threat of fines and civil law claims for damages will raise the standard of care. It is more likely that investment firms will withdraw from this sector of business.

III. Dealing with conflicts of interest: Commission-based advice versus fee-based advice

1. Previous standard from MiFID I

a) Conflicts of interests for commission-based advice

The wording of the Securities Investment Services Directive of 1993 had already stated that investment recommendations must be made in the "best interests" of clients.[100] These investment advice duties were given statutory force in MiFID I and the MiFID Implementation Act (FRUG).[101] In terms of a suitability assessment, the regulatory concept of providing investor-oriented advice differs from simple explanation by way of provision of information in three ways: (1) Instead of abstract, standardised information, clients must be given all the information they need to be able to understand and evaluate the specific investment risks of the recommended financial product.[102] (2) The appropriateness assessment (Section 31 (4) sentence 2 of the Securities Trading Act –WpHG) goes beyond the suitability assessment (Section 31 (3) of the Securities Trading Act – WpHG) in that the appropriateness assessment of the investment product for the client must be based on the client's knowledge

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[97] BGH, judgment of 22.3.2011, Az. XI ZR 33/10, BGHZ 189, 13, 25 marginal note 29 - *Zinswette*.

[98] See Section 5a (1) sentence 1, 2. Alt. WpDVerOV (fn. 61).

[99] *J. Köndgen*, Grenzen des informationsbasierten Anlegerschutzes – also comment on BGH, judgment of 22.3.2011, Az. XI ZR 33/10, BKR 2011, 283, 285; On similar criticism of important investor information under the Investment Code (KAGB), see *T. Möllers*, NJW Editorial: Alleingang beim Anlegerschutz – das KAGB, NJW 2012, volume 52, I.

[100] See Art. 11 (1) sentence 4 (1) of the Securities Investment Services Directive (fn. 28). On this, see *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 172.

[101] Act Implementing the Markets in Financial Instruments Directive and the Commission's Implementing Directive (FRUG) of 16.7.2007, BGBl. I, p. 1330.

[102] On the substantive duty to provide information under civil law, see *T. Möllers/T. Ganten*, Die Wohlverhaltensrichtlinie des BAWe im Lichte der neuen Fassung des WpHG – Eine kritische Bestandsaufnahme, ZGR 1998, 773, 788 f.; From the supervisory law perspective, the existence of a substantive dity to provide information is contested. In favour of this, see *A. Fuchs*, in: A. Fuchs (Publ.), WpHG, 2009, § 31 marginal note 255; *D. Einsele*, Anlegerschutz durch Information und Beratung, JZ 2008, 477, 481 f.; also *P. Mülbert*, Anlegerschutz bei Zertifikaten, -Beratungspflichten, Offenlegungspflichten bei Interessenkonflikten und die Änderungen durch das Finanzmarkt-Richtlinie-Umsetzungsgesetz (FRUG), WM 2007, 1149, 1156; *R. Veil*, Vermögensverwaltung und Anlageberatung im neuen Wertpapierhandelsrecht - eine behutsame Reform der Wohlverhaltensregeln?, ZBB 2008, 34, 38 f.

and experience and their financial risk tolerance.[103] (3) A personal recommendation for a certain financial product is to be made on this basis.[104] Therefore, in accordance with the provisions of the Securities Trading Act (WpHG), the investment advice must always be investor-centric. Asset management differs from investment advice in that in the latter it is the client who makes the investment decision independently.[105]

A recommendation is assessed as suitable under the provisions of MiFID I if the product meets the investment aims (length of investment, risk tolerance, purpose of investment)[106] and financial strength of the client, and the client is able to understand the risks.[107]

Giving investment advice is time and cost-intensive, and investment advisers are subject to considerable commission pressure. It is not surprising that clients are often given recommendations for the product that generates the highest commission, though this is not necessarily the one that is most suitable for their needs.[108]

b) Stipulations of MiFID I Implementation Directive 2006/73

The MiFID I Implementation Directive 2006/73[109] substantiates the general duty to avoid such conflicts of interest by generally outlawing inducements. This provision was implemented in Germany in Section 31 (1) No. 2 of the Securities Trading Act (WpHG).[110] Inducements[111] are only permissible if they allow or are necessary for the provision of investment services (Section 31d (5) WpHG), or the inducement is from a third party commissioned by the client, or if the investment services enterprise grants such an inducement to such a third party (Section 31d (1) sentence 2 WpHG). Inducements would

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[103] For extent of assessment, see § 6 (1) No. 1 WpDVerOV (fn. 61).

[104] *F. Braun/V. Lang/A. Loy*, in: J. Ellenberger/H. Schäfer/P. Clouth/V. Lang (Publ.), Praktikerhandbuch Wertpapier- und Derivategeschäft, 4th Edn. 2011, marginal note. 301.

[105] *R. Sethe,* Anlegerschutz im Recht der Vermögensverwaltung, 1st Edn. 2005, p. 26 f.; *T. Möllers,* Vermögensbetreuungsvertrag, graue Vermögensverwaltung und Zweitberatung, – Vertragstypen zwischen klassischer Anlageberatung und Vermögensverwaltung, WM 2008, 93 ff.; *A. Fuchs*, in: A. Fuchs (Publ.), WpHG, 2009, § 31 marginal note. 244.

[106] See Section 6 (1) No. 2 WpDVerOV (fn. 61).

[107] *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31 marginal note 151; *A. Fuchs*, in: A. Fuchs (Publ.), WpHG, 2009, § 31 marginal note 257 ff.

[108] *K. Uffmann*, Fehlanreize in der Anlageberatung durch interne Vertriebsvorgaben, JZ 2015, 282 ff.

[109] Art. 26 Implementation Directive 2006/73 (fn. 30).

[110] Section 31d (1) sentence 1 WpHG; See *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31d marginal note. 4; *J. Koch*, in: E. Schwark/D. Zimmer, KMRK, 4th Edn. 2010, § 31d WpHG marginal note 2; *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, § 31d marginal note 4; *C. Herresthal*, Die Grundlage und Reichweite von Aufklärungspflichten beim Eigenhandel mit Zertifikaten, ZBB 2012, 89, 99.

[111] Includes commissions, other fees or other cash, and any non-cash benefits, Section 31d (2) WpHG.

also be permissible if they enhance the quality of the service to the client, do not impair the proper provision of the service in the interest of the client, and the existence of the inducement is disclosed (Section 31d (1) sentence 1 Nos. 1, 2 WpHG).[112]

2. Solutions from the German legislature – pressing ahead again

a) Kickbacks and fee-based advice

In addition to regulatory rules, the Federal Court of Justice (BGH) has interpreted a civil law advisory contract to include a duty to disclose any kickbacks. This interpretation has been heavily criticised, as it is clear to business partners that a commercial service will only be provided for a fee.[113] Parties involved in proprietary trading are not required to disclose trading margins.[114]

Although MiFID does not have to be implemented until 3 January 2017, the German legislature has already passed the Fee-Based Investment Advice Act (*Honoraranlage-beratungsgesetz*)[115] in advance of the MiFID provisions. The new rules already take account of the MiFID II provisions, including the general prohibition of third-party fees (Section 31 (4c) No. 2 sentence 3 WpHG) and introduces a duty to disclose financial instruments issued or provided by the investment firm itself or by entities having direct links with the investment firm (Section 31 (4c) sentence 1 WpHG).[116]

b) Investment advice minutes, certificate of competence, registration obligation and complaints register

The German legislature went further and also introduced investment advice minutes – Section 34 (2a) of the Securities Trading Act (WpHG).[117] The intention was to relieve some of

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[112] See *I. Koller*, in: H.-D. Assmann/S. Schneider (Publ.), WpHG, 6th Edn. 2012, 31d marginal note 27 ff.

[113] *H. Grigoleit*, Anlegerschutz, Produktinformation und Produktverbote, ZHR 177 (2013), 264, 291; previously *M. Habersack*, Die Pflicht zur Aufklärung über Rückvergütungen und Innenprovisionen und ihre Grenzen, WM 2010, 1245; 1251; *P. Mülbert*, Anlegerschutz bei Zertifikaten, -Beratungspflichten, Offenlegungspflichten bei Interessenkonflikten und die Änderungen durch das Finanzmarkt-Richtlinie-Umsetzungsgesetz (FRUG), WM 2007, 1149, 1160.

[114] BGH, judgment of 27.9.2011, Az. XI ZR 182/10, NJW 2012, 66 (guiding principle 5); BGH, judgment of 27.9.2011, Az. XI ZR 178/10, NJW-RR 2012, 43, 47 marginal note 47.

[115] See below fn. 192; Re Sections 31 (4b), (4c), Sections 33 (1) No. 3a, 36c, 36d WpHG, see *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, §§ 36c, 36d marginal note 1 ff.

[116] For another view on civil law duty, BGH, judgment of 19.12.2006, Az. XI ZR 56/05, BGHZ 170, 226, 233 marginal note 21 with comment *T. Möllers/T. Wenninger*, BGH: Aufklärungspflichten der Bank über verdeckte Rückvergütungen (Retrozessionen/kick back-Provision) beim Vertrieb von Anteilen an Investmentfonds, LMK 2007, 220857.

[117] Section 34d (2a) WpHG, introduced by Art. 4 No. 4 SchVG (fn. 190).

the pressure on the Federal Financial Supervisory Authority (BaFin) in its supervision of investment services enterprises, and give clients evidence to allow them to pursue civil remedies if they were given incorrect advice.[118]

The German legislature went further than the MiFID provisions with the introduction of the Investor Protection Improvement Act (*Anlegerschutz- und Funktionsverbesserungsgesetz*):[119] it substantiated the competence provisions for staff,[120] required registration with BaFin, and introduced a complaints register at BaFin (Section 34d WpHG).[121]

3. Numerous changes to the legislative process: MiFID II Proposal, MiFID II and the planned Technical Advices Regulation

a) Introduction of fee-based advice (Art. 24 (4) and (7) MiFID II)

MiFID II was the first law at a European level to distinguish between independent and non-independent investment advice. Fee-based advice can be found in the United Kingdom,[122] the Netherlands, or the USA.[123] The traditional advice is usually given free of charge; the conflict of interest arises when the advisor recommends financial instruments issued or provided by the investment firm itself or receives kickbacks from a third party. Fee-based advice seeks to avoid exactly this problem. In the insurance industry there are insurance brokers; fee-based advice means that the advisor receives the fee only from the customer and not from any third party. MiFID II requires advisors to disclose whether or not the advice is given on an independent basis.[124] Fee-based advice prohibits payment of fees by third

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[118] Regs. to SchVG of 29.4.2009, BT printed papers 16/12814, p. 14, 27 f; *J.-U. Franck*, Unionsrechtliche Regulierung des Wertpapierhandels und mitgliedstaatliche Gestaltungsspielräume: Dokumentation der Anlageberatung als Paradigma, BKR 2012, 1, 2.

[119] See below, fn. 191.

[120] Regulation relating to the use of employees in the provision of investment advice, as distribution officers or as compliance officers and to the reporting requirements pursuant to section 34d of the Securities Trading Act dated 21.12.2011, BGBl. I, p. 3116, last amended by Art. 2 of Act dated 15.7.2003, BGBl. I, p. 2390 (WpHG Employee Notification Regulation – WpHGMaAnzV).

[121] See *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 34d marginal note 14 ff.

[122] Rules 6.2A.3, 6.2A.4A COBS, available at: <fsahandbook.info/FS/html/handbook/COBS/6/2A>.

[123] *D. Manzei*, Rechtsvergleichende Betrachtung von Verhaltensregeln für Wertpapierdienstleistungsunternehmen im Privatkundengeschäft unter deutschem wie US-amerikanischem Aufsichtsrecht, WM 2009, 393, 396.

[124] Art. 24 (4) sentence 2 (a) (ii) MiFID II (fn. 33).

parties[125] and requires a comprehensive market analysis. The fee-based advice may not be limited to financial instruments issued or provided by the investment firm itself.[126]

b) Prohibition of commission-based advice - ESMA and the "Technical Advices"?

During the legislative process, the EU Parliament had proposed to make it possible for Member States to entirely prohibit kickbacks for commission-based advice.[127] If Member States had taken up this option, it would have meant the end of commission-based advice. However, this rule was thrown out by the Economic and Monetary Affairs Committee of the European Parliament. Political discussions now turn on the issue of if only fee-based advice should be permitted in the future. The German Banking Federation fears that ESMA's Technical Advices could tighten up provisions on permitted fees to such an extent that commission-based advice would become virtually impossible.[128]

ESMA's Consultation Paper dated 22 May 2014 included a formulation of a prohibition on commissions.[129] After protests from business, this prohibition was significantly watered down in the Final Report dated 19 December 2014.[130] There will be no certainty on the matter until the Level II implementation provisions have been passed. ESMA's Technical Advices also need to be approved by the Economic and Monetary Affairs Committee of the European Parliament before they become binding. The responsible Parliamentarians have already indicated that they will fight the provision.[131] There is a bit of a war going on behind closed doors.

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[125] Art. 24 (7) (b) MiFID II (fn. 33).

[126] Art. 24 (7) (a) MiFID II (fn. 33).

[127] Art. 24 (5) of Amendments adopted by the European Parliament on 26 October 2012 on the proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast), P7_TA-PROV(2012), 0406; See *T. Möllers/M. Poppele*, Paradigmenwechsel durch MiFID II: divergierende Anlegerleitbilder und neue Instrumentarien wie Qualitätskontrolle und Verbote, ZGR 2013, 437, 465, 471 f.

[128] See *Anon*, Bankberatung könnte teuer werden, FAZ dated 21.3.2015, p. 31.

[129] Commissions should not be permissible when they are only used to pay for or provide goods or services that are essential for the recipient firm in its ordinary course of business; see Consultation Paper ESMA/2014/549 dated 22.5.2014 (fn. 36).

[130] Commission should be allowed if a client receives one of the following services: - investment advice and access to a wide range of products, including third-party products, investment advice and regular appropriateness assessments, or other regular services, or access to a wide range of products, including third-party products, and regular reports about value increases and costs or other information tools; see Final Report ESMA/2014/1569, 19.12.2014, p. 127 ff., see <http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf>.

[131] Member of the EU Parliament *Markus Ferber*, see <http://www.markus-ferber.de/verschiedenes/presse-aktuell-single-view/article/provisionsverbot-durch-die-hintertuer.html>.

c) Striking out provisions on sales incentives

The original intention of the MiFID II Proposal was that the remuneration structures involved should "not impede compliance with its obligation to act in the best interests of clients."[132] With respect to provision of advice and sales to retail clients, the Proposal envisaged that the remuneration structures should not prejudice the ability of advisors to provide an objective recommendation and clear and understandable information.[133] Remuneration should not be largely dependent on targets for the sale or profitability of the recommended products.[134] In advising retail clients, the advisor's performance assessment may also not provide an incentive for them to recommend a particular investment product when another product would better meet that client's objectives.[135] Unfortunately, these provisions were deleted from the final version of MiFID II.

d) Certificate of competence and monitoring by compliance officials, suitability report

MiFID II requires investment firms to ensure that persons giving investment advice to clients have the necessary knowledge and competence to fulfil their duties and to publish the criteria used for assessing such knowledge and competence.[136] A compliance management body shall be responsible for a remuneration policy aimed at avoiding conflict of interest in client relationships (Art. 9 (3) (c) MiFID II).[137] Investment firms must also ensure that they do not remunerate or assess staff performance in a way that conflicts with their duty to act in the best interests of clients (Art. 24 (10) MiFID II).

MiFID II also states that for recommendations for a package of services each individual product and the overall product package should be suitable for the client.[138] A

[132] Art. 24 (1b) sentence 1 MiFID II-E (EUP) (fn. 32).

[133] Art. 24 (1b) sentence 2 MiFID II-E (EUP) (fn. 32).

[134] Art. 24 (1b) sentence 3 (a) MiFID II-E (EUP) (fn. 32).

[135] Art. 24 (1b) sentence 3 (b) MiFID II-E (EUP) (fn. 32).

[136] Art. 25 (1) MiFID II (fn. 33).

[137] The proposal that where there are contraventions the management bodies should be subject to personal criminal and civil penalties, independent of the national legal system, was deleted: Art. 9 (8a) MiFID II-E (EUP) (fn. 32).

[138] Art. 25 (2) second para. MiFID II (fn. 33).

MiFID II suitability report should also inform the clients how the advice has been tailored to their own personal requirements.[139]

4. Evaluation

a) German legislature pressing ahead

German influence to retain the present forms of commission-based advice was impossible to ignore. The Proposal for MiFID II was toned down accordingly. However, there was an attempt to temper the conflicts of interest by raising the competence certification requirements and evidencing the suitability of the advice by providing documentation in the form of investment advice minutes. So long as the commission-based advice remains “free of charge”, there is no protection against the investment firm recommending its own financial products instead of objectively searching the market for the most suitable products for the client. Therefore, fee-based advice is an important addition to commission-based advice.

b) Conflict: commission-based advice versus fee-based advice

The positive about fee-based advice is that the classical conflict of interest of commission-based advice is no longer present. However, at €150–350 per hour, fee-based advice does not come cheap. It normally does not make sense unless the investor has an investment sum of at least €50,000. This means that fee-based advice is effectively excluded for large sections of the population. Although fee-based advice has been available in Germany for many years already, it is not used much by investors.[140] In my opinion, it would be overly paternalistic to allow only for one form of advice – each has its own advantages and disadvantages. Therefore, as a first step the legislature should permit other forms of advice than just commission-based and fee-based advice, and not just prohibit commission-based advice. Execution-only transactions, without any form of suitability or appropriateness assessment are already allowed – Section 31 (7) of the Securities Trading Act (WpHG).[141] Other models are already being developed in the USA – for example robo advice, or

[139] Art. 25 (6) second para. MiFID II (fn. 33): “When providing investment advice, the investment firm shall, before the transaction is made, provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client”.

[140] For arguments in favour and against, see *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, §§ 36c, 36d marginal note 9 ff.; *H. Grigoleit*, Anlegerschutz, Produktinformation und Produktverbote, ZHR 177 (2013), 264, 297; *M. Poppele*, Kapitalmarktinvestmentprodukte (PRIP)-Horizontaler Privatanlegerschutz im Lichte der MiFID II, Augsburg 2015 (Diss.), p. 463.

[141] Based on Art. 19 (6) MiFID I (fn. 7); see also *A. Fuchs*, in: A. Fuchs (Publ.), WpHG, 2009, § 31 marginal note 302 ff.; *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31 marginal note 394 ff.

computer algorithms that replace traditional investment advice.[142] Such forms of investment advice can be offered much more cheaply. It would be helpful to include such alternative forms of advice in the laws by way of example, and this would encourage the development of alternative forms of advice. However, transparency for investors must remain the highest priority, so that they can clearly understand the advantages and disadvantages of the various advice forms and then decide on a certain form.

c) Minimum harmonisation and stricter national laws

With the introduction of a compliance regulation to ensure strict separation of commission-based advice and fee-based advice (Section 33c (3a) WpHG),[143] a register of fee-based advisors (Section 36c WpHG) and protection of the professional title (Section 36d WpHG), the German legislature exceeds the provisions of MiFID II. This paper has already mentioned the issue of whether a national legislature may be allowed to pass stricter laws. Recital 5 of MiFID II refers only to "minimum standards" and, unlike the Transparency Directive,[144] does not specify a mandatory standard. Therefore, the presumption is raised that there is only a minimum standard of harmonisation and stricter national laws may be permissible, and therefore the stricter German laws may be permissible.[145] However, this again relativizes the desired "level playing field"; instead, German financial market participants are subject to additional burdens. This also applies to the German desire to retain commission-based advice. The Commission quite evidently wished to make concessions to individual Member States.[146]

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[142] On "robo advice", offered in the USA by *Betterment, Wealthfront, Jemstep* oder *Personal Capital*, see *G. Braunberger*, Der Roboter als Anlageberater, FAZ, 12.6.2014, available at: <faz.net/aktuell/finanzen/meine-finanzen/sparen-und-geld-anlegen/robo-advice-der-roboter-als-anlageberater-12969006.html>; *K. Bode*, Empfohlen vom Computer, Die Zeit, 8.1.2015, p. 26.

[143] Here Regs. BT Printed papers 17/122295, p. 16.

[144] Compare Art. 3 Transparency Directive (fn. 21); also *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook", ZGR 2014, 544, 567, which – though without reasons – assumes full harmonisation by MiFID II.

[145] See already *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, §§ 36c, 36d marginal note 17 ff.

[146] Other examples for the Transparency Directive (fn. 21), see *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook", ZGR 2014, 544, 570 ff.

IV. Implementation using civil law

Until now, the European legislature has introduced only a few civil law liabilities, namely for incorrect prospectuses[147], ratings[148], or within the scope of the Transparency Directive[149].

1. Civil law liability under MiFID I

a) Different standard of civil law judicial interpretation in Germany

In Germany, there are some special statutory legal liabilities, such as for incorrect prospectuses[150], ad-hoc notifications[151] or incorrect offer documentation[152]. Could the duties of the investment firms also be enforced by civil law liability? There was also fierce debate as to what extent the public regulatory law under MiFID I also carried civil law obligations at a European or national level, as such obligations would be enforceable with claims for damages.[153] There is an extensive body of civil law decisions on incorrect investment advice,[154] but these cases lead to curious results. In some areas public law and civil law obligations run *parallel,*[155] but in some areas civil law obligations are more *onerous*. An example of this is the interest-swap decision where the Federal Court of Justice (BGH) required that the advice and information about the investment risk provided to a client should ensure that the client then had the same level of knowledge and understanding of the

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[147] Re Art. 6 of the Prospectus Directive (fn.17), see *T. Möllers/E. Steinberger*, Die BGH-Entscheidung zum Telekom-Prozess und das europäische Anlegerleitbild, NZG 2015, 329, 334.

[148] Re Art. 35a of the Rating Regulation (fn. 27), see *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 17 marginal note 29 ff.; *T. Möllers/C. Niedorf*, Regulation and Liability of Credit Rating Agencies, 11 ECFR 333, 346 (2014); *D. Einsele*, Kapitalmarktrecht und Privatrecht, JZ 2014, 703, 708 f.; *R. Veil/L. Teigelack*, in: R. Veil (Publ.), Europäisches Kapitalmarktrecht, 2nd Edn. 2014, § 27 marginal note 73.

[149] Re Art. 37 of the Transparency Directive (fn.21), see *T. Möllers*, Effizienz als Maßstab des Kapitalmarktrechts., AcP 208 (2008), 1, 28; *S. Mock*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 37v marginal note 143.

[150] Sections 21, 22 of the Securities Prospectus Act (WpPG); see BGH, judgment of 12.7.1982, Az. II ZR 175/81, NJW 1982, 2823 – Beton- und Monierbau; BGH, judgment of 18.9.2012, Az. XI ZR 344/11, BGHZ 195, 1 - Wohnungsbaugesellschaft Leipzig West; BGH, decision of 21.10.2014, Az. XI ZB 12/12, NZG 2015, 20 - Telekom; on this, see *T. Möllers/E. Steinberger*, Die BGH-Entscheidung zum Telekom-Prozess und das europäische Anlegerleitbild, NZG 2015, 329 ff.

[151] For an overview of current grounds for liability and judgments, see in detail *T. Möllers/F. Leisch*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, §§ 37b, c marginal note 1 ff.

[152] *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 12 marginal note 1 ff.; However, there has not yet been a decision made on Section 12 of the Securities Acquisition and Takeover Act (WpÜG).

[153] For current state of dispute, see *W.-H. Roth*, Die "Lehman-Zertifikate"-Entscheidungen des BGH im Lichte des Unionsrechts, ZBB 2012, 429, 436; *C. Herresthal*, Die Grundlage und Reichweite von Aufklärungspflichten beim Eigenhandel mit Zertifikaten, ZBB 2012, 89, 103; *T. Möllers*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, § 31 marginal note 17 ff.

[154] This is now widespread. For evidence, see *H. Edelmann*, in: H.-D. Assmann/R. Schütze (Publ.), Handbuch des Kapitalanlagerechts, 4th Edn. 2015, §§ 3 f.

[155] See fn. 47.

transaction as the advising bank.[156] This decision was heavily criticised in academic literature.[157] It is not possible to provide such a level of advice in practice, especially when the standard is not the state of knowledge of the individual advisor but of the bank that developed the products.[158] Conversely, the national civil law standard can also be *lower*, such as when the Federal Court of Justice declined to uphold the public law norm to protect the injured party within the meaning of Section 823 (2) of the Civil Code (BGB) and allow a civil law claim for damages.[159] Finally, there is one last deficiency: In Germany, various judgments lead in different directions, meaning that public law and civil law can be contradictory.[160]

b) Different protection standards in various Member States

In contrast to the legal position in Germany, the Austrian Supreme Court of Justice (OGH) has upheld support for giving civil law effect to public law liabilities.[161] The same applies to

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[156] BGH, judgment of 22.3.2011, Az. XI ZR 33/10, BGHZ 189, 13, 25 marginal note 29 - Zinswette.

[157] *S. Grundmann*, Wohlverhaltenspflichten, interessenkonfliktfreie Aufklärung und MIFID II - Jüngere höchstrichterliche Rechtsprechung und Reformschritte in Europa, WM 2012, 1745, 1752; *J. Köndgen*, Grenzen des informationsbasierten Anlegerschutzes – also comment on BGH, judgment of 22. 3. 2011 –Az. XI ZR 33/10, BKR 2011, 283: „*Man darf deshalb getrost unterstellen, dass nicht einmal jeder durchschnittlich befähigte Kundenberater zwischen Konstanz und Flensburg das kunstvolle Design dieser Produkte zur Gänze durchschaut hat.*“ (Translation: Therefore, one can confidently assume that not even the averagely qualified investment advisor across the length and breadth of this country has been able to understand the clever design of these products); *C. Schmitt*, Aktuelle Rechtsprechung zur Anlageberatung bei OTC-Derivaten, BB 2011, 2824, 2826; also *L. Klöhn*, comment on BGH, judgment of 22.3.2011-XI ZR 33/10, Schadensersatz wegen unzureichender Aufklärung über ein Zinsswap-Geschäft, ZIP 2011, 762, 763; for a critical view, *M. Lehmann*, Zum Schadensersatz bei Beratungspflichtverletzungen der Bank im Zusammenhang mit Zinsswap-Verträgen, JZ 2011, 749, 750 ff.

[158] *T. Möllers/M. Poppele*, Paradigmenwechsel durch MiFID II: divergierende Anlegerleitbilder und neue Instrumentarien wie Qualitätskontrolle und Verbote, ZGR 2013, 437, 469 f.

[159] BGH, judgment of 22.6.2010, Az. VI ZR 212/09, BGHZ 186, 58 marginal note 26 ff. re Section 34a (1) sentence 1 WpHG; BGH, judgment of 19.2.2008, Az.: XI ZR 170/07, BGHZ 175, 276 marginal note 18 with further evidence to Section 32 (1) (1) WpHG; BGH, judgment of 13.12.2011, Az. XI ZR 51/10, BGHZ 192, 90 marginal note 20 ff. - IKB on Section 20a WpHG.

[160] BaFin levied an administrative fine against Daimler AG due to late submission of ad hoc notification, but the Higher Regional Court (OLG) in Stuttgart found in favour of Daimler AG; see OLG Frankfurt, judgment of 12.2.2009, Az. 2 Ss-OWi 514/08, 2 Ss OWi 514/08, NJW 2009, 1520, and also OLG Stuttgart, judgment of 15.2.2007, Az. 901 Kap 1/06, NZG 2007, 352; on this, see *T. Möllers*, Der BGH, die BaFin und der EuGH: Ad-hoc-Publizität beim einvernehmlichen vorzeitigen Ausscheiden des Vorstandsvorsitzenden Jürgen Schrempp, NZG 2008, 330 ff.; *T. Möllers/S. Seidenschwann*, Anlegerfreundliche Auslegung des Insiderrechts durch den EuGH, Das Ende der Daimler/Schrempp-Odyssee in Luxemburg, NJW 2012, 2762, 2764; *M. Wundenberg*, Perspektiven der privaten Rechtsdurchsetzung im europäischen Kapitalmarktrecht, Möglichkeiten und Grenzen der Harmonisierung der kapitalmarktrechtlichen Informationshaftung, ZGR 2015, 124, 155.

[161] OGH, judgment of 20.4.2005, Az. 7 Ob 64/04v, ÖBA 2005, 721, 725; OGH, judgment of 20.1.2005, Az. 2 OB 236/04a, ÖBA 2009, 635, 640; Also, on market manipulation pursuant to Section 48a (1) of the Stock Market Act (BörseG), see OGH, judgment of 24.1.2013, Az. 8 Ob 104/12w, ÖBA 2913, 438/1922 under 6.2. with further evidence; OGH, judgment of 15.3.2012, Az. 6 Ob 28/12d, RIS-Justiz RS0127724 under 3.4.; available at: <https://www.ris.bka.gv.at>.

the Supreme Court of Cassation in Italy.[162] Sweden has a separate law that gives investors a claim for damages if they have been given incorrect investment advice.[163]

On top of this, there are differences in implementation of the laws. In Germany, after reforms the Capital Markets Model Case Act (KapMuG) now allows for joint claims for damages to be made by a class of complainants after incorrect advice has been provided.[164] Consumer organisations have also been strengthened: Acting as a sort of market watchman, they are supposed to draw attention to black sheep at an early stage and ensure that they no longer participate in the markets.[165]

c) European provisions under MiFID I and MiFID II

In a preliminary reference decision in a Spanish case, the Court of Justice of the European Union (CJEU) has decided that MiFID I does not require Member States to introduce corresponding civil law liability.[166] Therefore, it will not be possible to argue civil law sanctions *de lege lata* as a binding provision of European law.[167] But it has not yet been decided if Member States *may* introduce civil law liability.[168]

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[162] Cass. Civ., judgment of 17.2.2009, n. 3773; Tribunale Salerno, judgment of 15.10.2009, in: Giur. It. 2010, 1840 ff.; see also *A. Perrone/S. Valente*, Against All Odds: Investor Protection in Italy and the Role of Courts, 13 EBOR 31, 33 (2012).

[163] *F. Walla*, The Swedish Capital Markets Law from a European Perspective, 22 EBLR 211, 218 f. (2011).

[164] Act on Model Case Proceedings in Disputes under Capital Markets Law (Capital Markets Model Case Act – KapMuG) of 19.10.2012, BGBl. I, p. 2182; on this, see B. Hess/F. Reuschle/B. Rimmelspacher (Publ.), Kölner Kommentar zum KapMuG, 2nd Edn. 2014; *T. Möllers/F. Leisch*, in: H. Hirte/T. Möllers (Publ.), Kölner Kommentar zum WpHG, 2nd Edn. 2014, §§ 37b, 37c marginal note 523 ff. with further evidence.

[165] *Anon.*, "Marktwächter" für Finanzprodukte und digitale Dienste", FAZ, 27.3.2015, p. 25 and the Small Investor Protection Act (fn. 193).

[166] CJEU, judgment of 30.5.2013, Rs. C-604/11, ECLI: EU:C:2013:344 = NZG 2013, 786 ff. marginal note 57 – Genil 48 SL: "In the absence of EU legislation on the point, it is for the internal legal order of each Member State to determine the contractual consequences of non-compliance with those obligations, subject to observance of the principles of equivalence and effectiveness."

[167] *M. Wundenberg*, Perspektiven der privaten Rechtsdurchsetzung im europäischen Kapitalmarktrecht, Möglichkeiten und Grenzen der Harmonisierung der kapitalmarktrechtlichen Informationshaftung, ZGR 2015, 124, 135; in detail *M. Poppele*, Kapitalmarktinvestmentprodukte (PRIP)-Horizontaler Privatanlegerschutz im Lichte der MiFID II, Augsburg 2015 (Diss.); also on MiFID I, see *A. Hellgardt*, Europarechtliche Vorgaben für die Kapitalmarktinformationshaftung, AG 2012, 154, 165 ff.; *C. Seibt*, Europäische Finanzmarktregulierung zu Insiderrecht und Ad hoc-Publizität, ZHR 177 (2013), 388, 424 ff.

[168] On this, see *T. Möllers/M. Poppele*, Paradigmenwechsel durch MiFID II: divergierende Anlegerleitbilder und neue Instrumentarien wie Qualitätskontrolle und Verbote, ZGR 2013, 437, 469.

2. Extra-judicial settlements and civil law liability after MiFID II and PRIIP Regulation

a) MiFID II

During the legislative process, civil law claims for damages were discussed by the Commission[169] and by the Parliament, and civil law liability for Board Members was to be mandatory.[170] However, once again this version was watered down. The final version refers only to “compensation” or “other remedial action”, without specifying to whom this refers.[171] Nevertheless, the Directive does specify mandatory extra-judicial mechanisms for settling consumer complaints (Article 75), and consumer organisations may take action to ensure compliance with provisions (Article 74 (2) (b)).

b) PRIIP Regulation

The PRIIP Regulation requires Member States to set up complaint procedures (Art. 19 (a)). The Regulation is of particular interest from a legal theory perspective because, exceptionally, it formalises civil law claims for damages at the European level. Contraventions of prescriptions (uniform format, understandable language and content)[172] would be sanctioned with a claim for damages by the retail investor against the product manufacturer.[173] The original Proposal envisaged liability if the Key Information Document was not succinct, comprehensible or clear within the meaning of Article 6. It also contained a burden of proof in favour of the investor. If the investor could prove that a loss had been incurred due to reliance on the information provided, the burden of proof would be on the product manufacturer to show that the information sheet complied with statutory

[169] Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID) of 8.12.2010, No. 7.2.6, p. 63: “Introducing a principle of civil liability of investment services providers would be essential for ensuring an equal level of investor protection in the EU.” Available at: <http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf>.

[170] Art. 9 (8a) MiFID II-E (EUP) (fn. 32) states: “Without prejudice to the legal systems of the Member States, Member States shall ensure that where it is alleged that a member of the management board has breached the provisions of or has committed an offence in relation to matters falling within the scope of this Directive or of Regulation (EU) No .../... [MiFIR], he may be personally subject to criminal *and civil proceedings*.”

[171] Art. 69 (2) para. 3 MiFID II (fn. 33) states: “Member States shall ensure that mechanisms are in place to ensure that compensation may be paid or other remedial action be taken in accordance with national law for any financial loss or damage suffered as a result of an infringement of this Directive or of Regulation (EU) No 600/2014.”

[172] Art. 8 PRIIP Regulation (fn. 72).

[173] Art. 11 (1) PRIIP Regulation (fn. 72).

requirements.[174] Interested organisations complained that this would extend liability because the terms “succinct, comprehensible or clear” were too vague. In addition, national laws did not contain any provisions easing the burden of proof in favour of investors in this form. It is clear that these two objections were taken into account and the provisions are no longer to be found in the current version. The provisions to ease the burden of proof and the reference to Article 6 were deleted. Liability arises only if the Key Information Document is misleading or incorrect, or contradicts the provisions of Article 8.[175] In addition, loss is defined in accordance with national law or private international law. Finally, stricter national provisions are permissible (Article 11 (4)).

3. Opinion

a) Extra-judicial settlement

Extra-judicial settlement, which is included in both MiFID II and in the PRIIP Regulation, is innovative[176] and has already been successful in Germany with institutions such as the Banking Ombudsman.[177] But agreeing to settle disputes extra-judicially in this manner goes far beyond the voluntary extra-judicial settlement in the European Directive.[178]

b) Liability after the PRIIP Regulation

The innovative aspect is that liability is introduced for the first time to the area of providing information and advice. This innovation is to be welcomed. However, the formulation of the

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[174] Art. 11 (2), (3) Proposal for PRIIP Regulation (fn. 71); contraventions should also be sanctioned by supervisors – see Arts. 15 ff. Proposal for PRIIP Regulation (fn. 71); on this, see *M. Gruber*, PRIPs-Verordnung ante portas, ZFR 2012, 311, 313; *J. Seitz/A. Juhnke/S. Seibold*, PIBs, KIIDs und nun KIDs – Vorschlag der Europäischen Kommission für eine Verordnung über Basisinformationsblätter für Anlageprodukte im Rahmen der PRIPs-Initiative, BKR 2013, 1, 6 f.

[175] See fn. 75 f.

[176] Positive evaluation also in *N. Moloney,* EU Securities and Financial Markets Regulation, 3rd Edn. 2014, IV.11.6.2, p. 415.

[177] On the basis in European law under Art. 10 of Directive 97/5/EC of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers, OJ. L 43, 14.2.1997, pp. 25–27; see *T. Höche*, in: H. Schimansky/H.-J. Bunte/H.-J. Lwowski (Publ.), Bankrechtshandbuch, 4th Edn. 2011, § 3 marginal note 9 ff.

[178] At present, participation is only seen as voluntary, see Art. 1 of Directive 2013/11/EU of the European Parliament and of the Council of 21 May 2013 on alternative dispute resolution for consumer disputes and amending regulation (EC) No 2006/2004 and Directive 2009/22/EC (Alternative Dispute Resolution Directive), OJ L 165, 18.6.2013, pp. 63–79 (ADR Directive); See also Referentenentwurf des Bundesministeriums der Justiz und für Verbraucherschutz, Entwurf eines Gesetzes zur Umsetzung der Richtlinie über alternative Streitbeilegung in Verbraucherangelegenheiten und zur Durchführung der Verordnung über Online-Streitbeilegung in Verbraucherangelegenheiten (Draft law of the Federal Ministry of Justice and Consumer Protection to implement the Alternative Dispute Resolution Directive and to implement the Regulation on Online Dispute Resolution) dated 10.11.2014. Available at: <www.bmjv.de>.

constituent elements is already fixed where they refer to the law of Member States.[179] This means that ESMA or EIOPA would not have any competence to further substantiate the liability requirements. Nevertheless, the European regulators may still be able to draw up comparative legal models on liability.

c) Liability under MiFID II and the necessary harmonisation of civil law liability – European antitrust laws as a model

There are only traces of civil law liability to be found in MiFID II.[180] Some argue the view that a harmonisation of civil law liability would be absurd, as this would transform the Court of Justice of the European Union (CJEU) into a sort of super court of appeal that would have to make decisions on all sorts of civil law disputes.[181] Others demand that the different public law sanctions systems of Member States must first be brought more into line with each other.[182] Or there are fears that the introduction of civil law liability could lead to Anglo-American legal conditions with an excessive litigation industry.[183] However, the argument about a super court of appeal has been deflated by a decision of the CJEU. The Court has handed down many judgments in recent years in the areas of standard terms and conditions or unfair competition. Originally, the CJEU demanded a power of final substantiation,[184] but in later cases only claimed the right to develop "general criteria" with the application of these criteria being left up to national courts.[185] Lastly, experience in Germany with civil liability claims for incorrect advice has not resulted in an uncontrolled flood of legal claims.

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179 On the lack of substantiation competence of the European Untion in such reference clauses, see *T. Möllers*, Vollharmonisierung im Kapitalmarktrecht - Zur Regelungskompetenz nationaler Gerichte und Parlamente, in: B. Gsell/C. Herresthal (Publ.), Vollharmonisierung im Privatrecht, Die Konzeption der Richtlinie am Scheideweg?, 2009, p. 247, 249.

180 Arguing against liability in excess of the current status quo, see *M. Wundenberg*, Perspektiven der privaten Rechtsdurchsetzung im europäischen Kapitalmarktrecht, Möglichkeiten und Grenzen der Harmonisierung der kapitalmarktrechtlichen Informationshaftung, ZGR 2015, 124, 133; but, more positive, *N. Moloney*, EU Securities and Financial Markets Regulation, 3rd Edn. 2014, IV.11.6.2., p. 415.

181 *H. Grigoleit*, Anlegerschutz, Produktinformation und Produktverbote, ZHR 177 (2013), 264, 273.

182 *M. Wundenberg*, Perspektiven der privaten Rechtsdurchsetzung im europäischen Kapitalmarktrecht, Möglichkeiten und Grenzen der Harmonisierung der kapitalmarktrechtlichen Informationshaftung, ZGR 2015, 124, 154.

183 *N. Moloney,* EU Securities and Financial Markets Regulation, 3rd Edn. 2014, XI.4.1.3, p. 968; *H. Jackson/M. Roe,* Public and private enforcement of securities laws: Resource-based evidence, 93 JFE 207 ff. (2009).

184 CJEU, judgment of 27.6.2000, verb. Rs. C-240/98 to C-244/98, ECLI:EU:C:2000:346 = Slg. 2000, I-4941 marginal note 24 – Océano.

185 CJEU, judgment of 1.4.2004, Rs. C-237/02, ECLI:EU:C:2004:209 = Slg. 2004, I-3403 marginal note 23 – Freiburger Kommunalbauten; CJEU, judgment of 26.4.2012, Rs. C-472/10, ECLI:EU:C:2012:242 = EuZW 2012, 786 marginal note 22 – Invitel; CJEU, judgment of 14.3.2013, Rs. C-415/11, ECLI:EU:C:2013:164 = EuZW 2013, 464 marginal note 34 – Aziz.

V. Summary and outlook

1. Relationship between European and national laws

a) Minimum and maximum harmonisation

We have seen that the European legislature is extremely active. As regards minimum harmonisation and the directives, the latter have disadvantages for users from other Member States in that the search for applicable national provisions based on European law is usually made very difficult.[186] But there are also advantages: As demonstrated by the discussion on the permissibility of commission-based advice, it is often impossible to take account of national peculiarities. For this reason, the approach taken at the European level is minimum harmonisation, in order to preserve the individual approaches taken by Member States.[187] Today, it often seems to be a matter of chance or political wrangling whether, as a directive is being drawn up, provisions will implemented on the basis of minimum harmonisation or maximum harmonisation. There can be no doubt that there is a need for deeper dogmatic discussion as to when the competition between the different legal forms delivers a better result, and when harmonised uniform European law is preferable.[188] If the legislature has nothing to say on the matter, each individual provision should be examined to see if it is binding, or whether it permits stricter national provisions.[189] In order to avoid these extensive assessments, the European legislature should clearly state its position and say with respect to directives when minimum harmonisation applies, and when a binding maximum harmonisation is intended.

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[186] An overview of the different national laws can be found in *R. Veil* (Publ.), Europäisches Kapitalmarktrecht, 2nd Edn. 2014, Annex, p. 687 ff.; For unfair competition, see the studies of *T. Möllers/A. Heinemann*, The Enforcement of Competition Law in Europe, 2007; A. Foer/J. Cuneo (Publ.), The International Handbook on Private Enforcement of Competition Law, 2010.

[187] Generally, also *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook“, ZGR 2014, 544, 568 f.

[188] The combination of both is in part seen as a possible solution: see *M. Wundenberg*, Perspektiven der privaten Rechtsdurchsetzung im europäischen Kapitalmarktrecht, Möglichkeiten und Grenzen der Harmonisierung der kapitalmarktrechtlichen Informationshaftung, ZGR 2015, 124, 152; *Fleischer/Schmolke*, Die Reform der Transparenzrichtlinie: Mindest- oder Vollharmonisierung der kapitalmarktrechtlichen Beteiligungspublizität?, NZG 2010, 1241, 1248; *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook“, ZGR 2014, 544, 565.

[189] *T. Buchmann*, Umsetzung vollharmonisierter Richtlinien, 2008, p. 66 ff.; *T. Möllers*, Vollharmonisierung im Kapitalmarktrecht - Zur Regelungskompetenz nationaler Gerichte und Parlamente, in: B. Gsell/C. Herresthal (Publ.), Vollharmonisierung im Privatrecht, Die Konzeption der Richtlinie am Scheideweg?, 2009, p. 247 ff.

b) German legislature pressing ahead with changes

Although MiFID II does not have to be implemented by Member States until 3 January 2017, the German government has already implemented some of the measures. Some of the legislative measures introduced in Germany and worthy of mention are the Debt Securities Act (SchVG)[190] which introduced investment advice minutes; the Investor Protection and Capital Markets Improvement Act (AnSFuG) [191] which introduced information sheets and a registration obligation; the Fee-Based Investment Advice Act (*Honoraranlageberatungs-gesetz*) which introduced the provisions on fee-based remuneration;[192] and now the Small Investor Protection Act (*Kleinanlegerschutzgesetz*), which seeks to close gaps in grey areas after the Prokon affair.[193] Should this pressing ahead by a national legislature be regarded in a positive light, or does it have more disadvantages than advantages? The disadvantages have been shown to outweigh the advantages. Misusing citizens and market participants as guinea pigs and landing them with high costs just serves to weaken competition in the national economy.

c) Civil law liability in capital markets law

We are still at the genesis of a system of civil law liability in capital markets law. Above, we have shown two different approaches to civil law liability in MiFID II and the PRIIP Regulation. Whilst MiFID II almost totally avoids liability, the PRIIP Regulation introduces such a liability. A uniform European approach to liability is desirable *de lege ferenda*, as this is the only way to create a joint level playing field. Antitrust law has had experience with public law sanctions for breaches of the law by companies since 1958. In contrast to MiFID I, the Court of Justice of the European Union (CJEU) has called for civil law liability,[194] and this is now being implemented by the European legislature.[195] European antitrust law can provide useful experience here in order to steer legal considerations into a sensible direction. The

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[190] Act on Debt Securities (Debt Securities Act - SchVG) of 31.7.2009, BGBl. I, p. 2512.

[191] Act to Increase Investor Protection and Improve the Functioning of the Capital Markets (Investor Protection and Capital Markets Improvement Act) of 5.4.2011, BGBl. I, p. 538.

[192] Fee-Based Investment Advice Act (*Honoraranlageberatungsgesetz*) of 15.7.2013, BGBl. I, p. 2390.

[193] Draft Proposal for a Small Investor Protection Act (*Kleinanlegerschutzgesetz*) of 11.2.2015, BT printed papers 18/3994 and BR printed papers 638/14.

[194] CJEU, judgment of 20.9.2001, Rs. C-453/99, ECLI:EU:C:2001:465 = Slg. 2001, I-6314, 6324 marginal note 30 - Courtage/Crehan; CJEU, judgment of 13.7.2006, Rs. C-295/04 - C-298/04, ECLI:EU:C:2006:461 = Slg. 2006, I-6641, 6670 marginal note 94 f. Manfredi.

[195] Directive 2014/104/EU of the European Parliament and of the Council of 26 November 2014 on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union, OJ L 349, 5.12.2014, p. 1 – 19; on Proposal, see *T. Möllers*, Private Enforcement of Competition Law in Europe – The Directive Proposal for Damages For Infringements of Competition Law Provisions, 3 Europa e diritto privato 2014, 822–846.

interplay between application of public law and civil law needs to be better determined in advance, by introducing a mandatory effect of supervisors' decisions with respect to civil law complainants. This already applies in antitrust law at national and European levels (Section 33 (4) of the Act Against Restraints of Competition (GWB)).[196] The Directive on liability law also harmonises the definition of loss and questions of causality.[197]

2. Good legislative practice at the European level

a) Advantages of regulations

In the area of capital law, the European legislature is increasingly passing statutes in the form of regulations. Pursuant to Article 288 (2) of the Treaty of the Functioning of the European Union (TFEU), these regulations are directly applicable, unlike legislation passed in the legal form of a directive. So now regulations can be categorised both at the first level of the Lamfalussy Process and at the second level. First-level regulations include the Rating Regulation[198], the Market Abuse Regulation[199], and the Prospectus Regulation.[200] The advantages of this approach are that the same rules are thus applicable across the whole of the EU, thus increasing the level of harmonisation. However, this level of harmonisation is not really evident in practice. Users applying national rules have to assimilate the texts of the regulations and ESMA guidelines, and leave their national regulations to one side. Even if ESMA guidelines have now been translated into the official languages,[201] it is helpful to be able to use English as the working language, because not all documents are available in all languages. It would be helpful to have a source of academic (secondary) literature that could be accepted and applied across Europe. This could be in the form of traditional treatises, or the German form of commentaries. Or – more likely – there is a fear that the intensive stream of regulations from ESMA will make traditional academic literature redundant.[202] Another

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196 See the Commission's statement on the occasion of publishing the fine decision dated 19.10.2011, IP/11/1214, CRT-Glas, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1214&format=HTML&aged=0&language=DE&guiLanguage=en>; *T. Möllers/B. Pregler*, Civil Law Enforcement and Collective Redress in Economic Law , 2 Europa e Diritto Privato, 2013, 27, 39.

197 Arts. 3, 5 and 17 of Directive 2014/104/EU on certain provisions under national law (fn. 195); *T. Möllers*, Private Enforcement of Competition Law in Europe – The Directive Proposal for Damages For Infringements of Competition Law Provisions, 3 Europa e diritto privato 2014, 822, 826 f.

198 See above, fn. 27.

199 See above, fn. 19.

200 See above, fn. 18.

201 *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook", ZGR 2014, 544, 595.

202 *R. Kiem*, Book-Review: H.-D. Assmann/ U. Schneider (Publ.):Wertpapierhandelsgesetz, Kommentar, 6th Edn., in: ZHR 176 (2012) 456, 461; following him, *P. Mülbert*, Regulierungstsunami im europäischen Kapitalmarktrecht, ZHR 176 (2012), 369, 379.

option could be databanks to create a central correlation of laws and judicial decisions, and to also provide translations.[203] Such a databank, which includes various judicial decisions, already exists for the CISG[204] under UN Sale of Goods law.[205]

b) National laws becoming less important in capital markets law

A shocking and novel experience for German lawyers has been that more and more elements of this codification are effectively making German capital markets law redundant, because in future it is the European regulations that will be directly applicable in law instead of German legal provisions.[206] German lawyers learn about law by studying the Civil Code (BGB) – and they are trained with the terminological and systemic clarity of nineteenth-century pandectic science.[207] German laws in the area of capital markets law, such as the Securities Trading Act (WpHG), the Securities Acquisition and Takeover Act (WpÜG) and the Securities Prospectus Act (WpPG) are structured into a systematic unit that comprises a unified set of rules and regulations. Another example of this highly crafted systematic codification is the Investment Code (KAGB),[208] which implemented the UCITS IV Directive and the AIFM Directive.

c) Pandectics of the nineteenth Century: Inner and outer systems of European regulations in capital markets law

In recent years, the European legislature has been trying to merge and systematise its directives, but further linguistic and systematic precision is still required. From a systemic perspective, notification requirements under the Market Abuse Directive and Transparency Directive can be aligned, as is the case as implemented in France and Spain.[209] The rules on

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203 See the databank on European capital markets law (fn. 42); See also the suggestion of *N. Moloney,* EU Securities and Financial Markets Regulation, 3rd Edn. 2014, XI.4.1.3, p. 969 f.

204 United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980) (CISG).

205 For the CISG, see in general <http://www.cisg.law.pace.edu>; <http://www.cisg-online.ch> (Switzerland); <http://www.uc3m.es/cisg> (Spain); and <http://www.cisg.at> (Austria).

206 Applies for the Market Abuse Regulation (MarktmissbrauchsVO) (fn. 20) and the PRIIP Regulation (fn. 72).

207 Of note are *A. Thibaut*, System des Pandektenrechts, 3 volumes, 5th Edn. 1818; *G. F. Puchta*, Pandekten, 5th Edn. 1850; *B. Windscheid*, Lehrbuch des Pandektenrechts, 7th Edn. 1891; *H. Dernburg*, Pandekten, 3 volumes, 4th Edn. 1894; *F. Regelsberger*, Pandekten, 1 volume 1893; *R. Zimmermann*, in: Historisch-kritischer Kommentar zum BGB (HKK), 2003, before § 1 marginal note 6 ff.

208 *T. Möllers*, NJW Editorial: Alleingang beim Anlegerschutz – das KAGB, NJW 2012, vol. 52, I; T. Möllers/A. Kloyer (Publ.), Kapitalanlagegesetzbuch, 2013.

209 On this, see *M. Wundenberg*, in: R. Veil (Publ.), Europäisches Kapitalmarktrecht, 2nd Edn. 2014, § 32 marginal note 18; und *P. Koch*, in: R. Veil (Publ.), Europäisches Kapitalmarktrecht, 2nd Edn. 2014, § 19 marginal note 4 ff.

financial analysis do not fit under market abuse, and would be better housed in a finance and rating regulation.[210] Above, we have seen that sanctions under the PRIIP Regulation apply not only for EIOPA but also for ESMA.[211] As demonstrated, the sanctions mix on the legal consequences side is less consistent, and further action is required in this area.[212]

The EBA already has a Single Rulebook,[213] but it contains only the individual directives. ESMA is working on a uniform European Single Rulebook for Capital Markets[214] in line with English models.[215] But will this satisfy the requirements of German lawyers, who are trained in the inner and outer systems of codification? The outer system comprises the formal structure of a statute, the classification of the statute and the development of regulations. The inner system refers to the logical lack of contradictions and teleological consistency, and references a consistent system of value judgments.[216] It would be desirable to have rules that are consistent, that allow for systematic interpretation, that permit gaps in legal and methodical analysis to be filled by individual analogy, and in an ideal world that also has room for general principles.

d) Three steps to good legislative practice

MiFID II is a directive, MIFIR and the PRIIP Regulation are directly applicable regulations. It still seems to be a matter of chance whether the legal form chosen for a new law is a

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[210] On this, see *M. Wundenberg*, in: R. Veil (Publ.), Europäisches Kapitalmarktrecht, 2nd Edn. 2014, § 32 marginal note 18; *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook“, ZGR 2014, 544, 575.

[211] See above, II.4.d).

[212] Just as clear under reporter *Edgardo Maria Iozia* (fn. 44) under 3.12.

[213] *EBA*, The Single Rulebook, available at: <https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single>.

[214] See *ESMA*, <https://www.wko.at/Content.Node/branchen/oe/BankVersicherung/Chamber-of-Commerce-FMA.pdf>. On this, see *R. Veil*, Zeitenwende in der Kapitalmarktgesetzgebung. Europäisierung von Recht und Aufsicht, in: FS Hommelhoff, 2012, 1263 ff; *C. Gerner-Beuerle*, United in Diversity: maximum versus minimum harmonization in EU securities regulation, 7 CMLJ 317 ff. (2012).

[215] On previous FSA Handbook of the UK *Financial Service Authority*, see <http://www.fsa.gov.uk/handbook>. The FSA Handbook was replaced by the *Financial Conduct Authority (FCA),* Financial Conduct Authority Handbook, available at: <https://fshandbook.info/FS/html/FCA/>.

[216] See *P. Heck*, Begriffsbildung und Interessenjurisprudenz, 1932, p. 139, 142 ff.; *K. Engisch*, Die Einheit der Rechtsordnung, 1935, p. 2 f.; *ders.*, Sinn und Tragweite juristischer Systematik, in: Studium generale, 10. Jhg. 1957, p. 173 ff.; *C.-W. Canaris*, Systemdenken und Systembegriff in der Jurisprudenz, 2nd Edn. 1983, p. 19 ff. Followed by *U. Karpen*, Zum gegenwärtigen Stand der Gesetzgebungslehre in der Bundesrepublik Deutschland, ZG 1986, 5, 31; *E. Kramer*, Juristische Methodenlehre, 4th Edn. 2013, p. 93 ff.

directive or a regulation.[217] Academic literature sometime explains this selection on the temperament of the responsible department in the Commission.[218] Some seem to favour directives in order to take account of the principle of subsidiarity.[219] Others favour regulations, in order to pass effective statutes.[220] This lack of clarity cannot be sufficient and there should be clarification from a legal and methodological perspective as to how and when the decision is made between regulations and directives. Three considerations are possible here:

(1) Due to the principle of limited competence pursuant to Article 5 (2) of the Treaty on European Union (TEU), the European legislature must first establish the basis of competence. In passing European capital markets laws, the legislature bases its authority on Article 50 (2)(g), Article 53 (1) and Article 114 of the Treaty on the Functioning of the European Union (TFEU), although full harmonisation is only uncontested with respect to provisions harmonising the single market pursuant to Article 114 TFEU.

(2) The current form of the subsidiarity principle is in itself not sufficient to favour the legal form of the directive. In the opinion of the Court of Justice of the European Union (CJEU), the European legislature often enjoys a wide discretion in passing European laws.[221] Therefore, content issues concerning the circumstances of the subsidiarity principle are decisive. A regulation is preferable if there is no need for Member States to implement stricter rules. Or, put another way: So long as numerous minimum harmonisation clauses take account of special circumstances in individual Member States, the legal form should remain the directive. However, this does not exclude allowing alternative solutions within the form of a regulation. Conceivable would be a third MiFID round passed as a regulation to MiFIR III that at the same time allowed fee-based advice and commission-based advice. This model works for the European company (Societas Europaea – SE), which itself allows for both one-tier and two-tier systems.[222]

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[217] See *U. Schneider*, Die Vertreibung aus dem Paradies – oder auf dem Weg ins kapitalmarktrechtliche Arkadien?, AG 2012, 823, 824.

[218] *P. Mülbert*, Regulierungstsunami im europäischen Kapitalmarktrecht, ZHR 176 (2012), 369, 374.

[219] *W. Kahl*, in: C. Callies/M. Ruffert (Publ.), EUV/AEUV, 4th Edn. 2011, Art. 114 marginal note 27.

[220] *R. Veil*, Europäische Kapitalmarktunion, Verordnungsgesetzgebung, Instrumente der europäischen Marktaufsicht und die Idee eines „Single Rulebook", ZGR 2014, 544, 568.

[221] See CJEU, judgment of 14.12.2004, Rs. C-210/03, ECLI:EU:C:2004:802 = Slg. 2004, I-11893 marginal note 46 ff. – Swedish Match; CJEU, judgment of 6.12.2005, Rs. C-66/04, ECLI:EU:C:2005:743 = Slg. 2005, I-10553 marginal note 45 - United Kingdom / Parliament and Council; *W. Kahl*, in: C. Callies/M. Ruffert (Publ.), EUV/AEUV, 4th Edn. 2011, Art. 114 marginal note 59.

[222] Arts. 38–60 of Regulation (EG) Nr. 2157/2001 of the Council dated 8.10.2001 on the Statute for a European company (SE), OJ L 294, 10.11.2001, p. 1 - 33; *T. Möllers*, Gesellschafts- und Unternehmensrecht, kleinere und mittlere Unternehmen, in: R. Schulze/M. Zuleeg/S. Kadelbach (Publ.), Europarecht, Handbuch für die deutsche Rechtspraxis, 3rd Edn. 2015, § 18 marginal note 178 ff.

(3) It has been argued above that national legislatures passing laws in advance of European laws creates higher transaction costs.[223] This applies even more so at the European level – more extensive use should be made of cost-benefit analyses.[224] Sets of rules that have a systematic basis would be an important step to reduce exaggerated complexity. Regulations require a certain systematic maturity. In the PRIIP Regulation, sanction possibilities for ESMA were forgotten, along with the possibility for consumer associations to intervene. Whether it will be possible to create a systematic, coherent set of rules remains to be seen.[225]

VI. Summary

1. European and national capital markets law is *fast-paced* and is *condensing* the Lamfalussy and de Larosière Processes to six relevant legal levels (incl. framework act, implementation act, supervisory authority action).
2. This double complexity is extended by four special features that result from the relationship between European and national laws: the problem of minimum and maximum harmonisation; the relationship between directives and directly applicable regulations; national legislatures pressing ahead with passing laws; and the influence of European law on non-harmonised areas of law. Three areas of regulation in MiFID II are supposed to stress this.
3. The PRIIP Regulation provides for the Key Information Document. The Product Information Sheet introduced in *advance* in Germany differs from the European stipulations in several points. Therefore, national provisions in advance make little sense.
4. Commission-based advice remains permissible at the European level, but is supplemented by the concept of fee-based advice. Investment advice minutes, certification of competence and other measures are supposed to reduce conflicts of interests for commission-based advice. As a stricter national set of rules, national provisions take account of several other national differences in addition to minimum harmonisation.
5. Civil law liability is sometimes stricter in Germany, and sometimes less strict than the obligations set out by the European legislature. In other Member States, there is a much stronger consonance of national and European duties for market participants. The different

[223] See above II.4.b).

[224] *H. Fleischer/K. Schmolke*, Die Reform der Transparenzrichtlinie: Mindest- oder Vollharmonisierung der kapitalmarktrechtlichen Beteiligungspublizität?, NZG 2010, 1241, 1248; *Willemaers*, The EU Issuer-Disclosure Regime 2011, p. 254.

[225] Not without reason has the Green Paper on building a capital markets union dated 18.2.2015 set aims including free movement of capital, to make it easier to access sources of finance across Europe, see Green Paper on Building a Capital Markets Union, 18.2.2015, Com(2015) 63 final, available under <http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_de.pdf>.

solutions for civil law liability in the various Member States are unsatisfactory because they counter the idea of a level playing field. A harmonisation of questions of causality and losses could be based on the latest Directive on private actions for damages for infringements of competition law provisions.

6. If the tendency should continue to harmonise European capital markets law by way of issuing regulations instead of directives, this would have a massive impact on the importance of systematically drawn up national capital markets laws. Therefore, it would be preferable if European capital markets law would be better structured in terms of form and content, and that it would more strongly state why this form of rules is efficient.

Reform of the regulation and governance of the Canadian payment system [*]

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[*] See B. Keefe, B. Geva, and E. Monas "Final Report of the Task Force for the Payment System Review Proposes Major Overhaul of the Canadian Payments System" (2012), 23 Jour. Banking and Finance Law and Practice, 315 from which the Report summary is taken. See also: B. Geva, "The Payment Industry After the Task Force report: Can Canada Learn from the Experience of Others?", (2012), 53 Can. Bus.L.J.:180. I am grateful to my colleagues at Torys, particularly, Blair Keefe, Peter Aziz, Eli Monas, Steven Slavens, and Melissa Prado, for advise, feedback, and partial drafts. Blair Keefe and I were members of the Regulatory Advisory Group that assisted the Task Force. All views and errors are mine.

I. Introduction: Payment Review Task Force

On June 18, 2010, the Canadian Minister of Finance announced the formation of the Task Force for the Payments System Review ("the Task Force") to make recommendations to the Minister to help guide the future of the payments system in Canada. After consulting with various interested parties, a final report, *Moving Canada into the Digital Age*,[1] together with four supporting policy papers and two discussion papers, was released on March 23, 2012. While the Minister "welcomed" the report, he did not specify whether, or to what extent, it would be implemented. Rather, he indicated that the government would establish a senior level advisory committee made up of private and public stakeholders to continue the positive dialogue.

The Task Force gave the current payments system failing grades and proposed an ambitious overhaul of the payments industry in Canada. The Task Force indicated that unless Canada develops a modern digital payments system, Canadians will be unable to fully engage in the digital economy of the 21st century, leading to a lower standard of living across the country and a loss in international competitiveness.

The Task Force also concluded that in the absence of a healthy competitive environment, government needed to create demand for a modern digital payments system that puts the needs of users first, protects the public interest and encourages all stakeholders to collaborate and innovate now and into the future.

In particular, the Task Force:

• Observed that transitioning to the digital economy is essential for Canada to not be left behind and that it is essential that the government play a leadership role in that process. Accordingly, the Task Force recommended that Canadian government must lead the transformation of the payments infrastructure so that it can innovate to meet the evolving payments needs of Canadians in a digital economy. In particular the government ought to,

1. Implement electronic invoicing and payments for all government suppliers and benefit recipients. This would include all steps of the purchase-to-pay and the order-to-receive cycles: sending and receiving invoices; dispute handling; acceptance, payment and collection; rec and archiving

2. Partner with the private sector to create a mobile ecosystem. The transformative power of a mobile ecosystem that combines payments, commerce and government services can be harnessed to tip the scales toward broad adoption of such a system

3. Propel the build of a digital identification and authentication regime to underpin a modernized payments system and protect Canadian's privacy

[1] The Task Force's Report is available at http://paymentsystemreview.ca/index.php/papers/moving-canada-into-the-digital-age/index.html.

• Recommended the passage of legislation to reform the governance of the Canadian payment system.

The balance of this paper will discuss the legal regime governing the Canadian payment system in the context of the Task Force's Report. The paper will describe the law prior to the Task Force's Report as well as how it was changed following it , albeit, not explicitly implementing it or even in response to it, and outline the further action undertaken by the Government of Canada. The paper will thus assess the adequacy of existing and anticipated changes by reference to both the report and the desired policies.

II. Governing Legislation: An Overview

Three federal statutes relate to the operation of national payment systems in Canada:

•The ***first*** statute is the Payment Clearing Settlement Act[2] ("PCSA") which addresses risk in clearing and settlement systems.

•The ***second*** is the Canadian Payments Act[3] ("CP Act") which covers two distinct subjects: (i) the Canadian Payments Association and its powers particularly in relation to national systems for clearing and settlement, and (ii) the Minister of Finance's powers to designate and regulate payment systems of national scope.

•The ***third*** statute is the Payment Card Networks Act[4] ("PCNA") designed to regulate national payment card networks. The *PCNA* addresses the bilateral relationship of a card network operator with the card issuer as well with the acquirer.

Among these statutes, only the CP Act had already went a revision subsequent to its enactment prior to the one discussed in this paper.[5]

III. The PCSA: Risk Control in Clearing and Settlement Systems

The PCSA deals with the supervision and regulation by the Bank of Canada ("BOC") of clearing and settlement systems for payment obligations among financial institutions. Under s. 2,

> *"clearing and settlement system"* means a system or arrangement for the clearing or settlement of payment obligations or payment messages in which
>
> - (*a*) there are at least three participants, at least one of which is a Canadian participant and at least one of which has its head office in a jurisdiction other than the jurisdiction where the head office of the clearing house is located;

[2] S.C. 1996, c. 6, Sch.

[3] R.S.C., 1985, c. C-21

[4] S.C. 2010, c. 12, s. 1834

[5] See Deborah Wilson, Isabelle Lepage, "The Canadian Payments System — Recent Legislative Changes", (2002-03), 18 BFLR 261

> - (*b*) clearing or settlement is all or partly in Canadian dollars; and
> - (*c*) except in the case of a system or arrangement for the clearing or settlement of derivatives contracts, the payment obligations that arise from clearing within the system or arrangement are ultimately settled through adjustments to the account or accounts of one or more of the participants at the Bank.
>
> For greater certainty, it includes a system or arrangement for the clearing or settlement of securities transactions, derivatives contracts, foreign exchange transactions or other transactions if the system or arrangement also clears or settles payment obligations arising from those transactions.

The passage of the statute was rationalized on the importance of such systems and their –risk free operation for "the stability of the financial system and the maintenance of efficient financial markets," and hence, for "the health and strength of the national economy" and "the national interest." In assigning the supervision and regulation tasks to the BOC, the Preamble to the PCSA goes on to explain that:

> the Bank of Canada, in promoting the economic and financial welfare of Canada, takes actions to promote the efficiency and stability of the Canadian financial system, including providing the means of settlement of Canadian dollar payments, acting as lender of last resort and, in consultation with other central banks, developing and implementing standards and practices to recognize and manage risk associated with systems for clearing and settling payment obligations

The object of the supervision and regulation tasks assigned to the BOC under the PCSA is the risk control in clearing and settlement systems. Originally, the scope of the statute was limited to "systemic risk", defined in s.2 as:

> the risk that the inability of a participant to meet its obligations in a clearing and settlement system as they become due, or a disruption to or a failure of a clearing and settlement system, could, by transmitting financial problems through the system, cause
>
> - (*a*) other participants in the clearing and settlement system to be unable to meet their obligations as they become due,
> - (*b*) financial institutions in other parts of the Canadian financial system to be unable to meet their obligations as they become due, or
> - (*c*) the clearing and settlement system's clearing house or the clearing house of another clearing and settlement system within the Canadian financial system to be unable to meet its obligations as they become due,

In December 2014 the definition was expanded by the addition of a new sub-paragraph:

- (*d*) an adverse effect on the stability or integrity of the Canadian financial system.

Furthermore, in December 2014 the list of risks covered by the PCSA was enlarged by the addition of "payments system risk", defined in s. 2 to mean:

> the risk that a disruption to or a failure of a clearing and settlement system could cause a significant adverse effect on economic activity in Canada by

- (*a*) impairing the ability of individuals, businesses or government entities to make payments, or
- (*b*) producing a general loss of confidence in the overall Canadian payments system, which includes payment instruments, infrastructure, organizations, market arrangements and legal frameworks that allow for the transfer of monetary value

Under PCSA s. 4(1),

> If the Governor of the Bank is of the opinion that a clearing and settlement system could be operated in a manner that poses a systemic risk or payments system risk and the Minister is of the opinion that it is in the public interest to do so, the Governor may designate the clearing and settlement system as a clearing and settlement system that is subject to this Part.

PCSA s. 6 authorizes BOC Governor to issue directives to a clearing house of a designated clearing and settlement system and its participants to take or refrain from an action in relation to systemic and payment system risks. As well, the PCSA provides the BOC with certain powers to enable it to monitor and control risk in designated systems:

1. Under PCSA s. 5 Systems must provide the Bank with such information as the Bank requests.
2. Under s. PCSA s. 9 Systems must provide the BOC with advance notice of any significant changes to the system, including changes to:
    - operation of the system;
    - the by-laws, rules or agreements which govern the system.
3. Under PCSA s. 10 the BOC may conduct audits and inspections of a system and its clearing house.
4. BOC may enter into an agreement with a System, governing such matters as netting, risk control, certainty of settlement and finality of payment, nature of financial arrangements among participants and operation of the system. This was provided in s. 5 of the original statute and is now addressed in s. 13.2.

The December 2014 amendment enhances the scope of the BOC Governor's power to review, prohibit and place conditions on a foreign institution's participation in a clearing and settlement system (s. 22.1). The amendment further provides clarifications with respect to the BOC's authority to impose annual fees for the administration of the Act (s. 12.1), its authority to act as a custodian and settlement agent for a clearing house (s. 12) and its authority to enter into oversight and information sharing agreements with governmental authorities and regulatory bodies (s. 13.3).

IV. CP Act: The CPA Mandate and Operations

The Canadian Payments Association (CPA) was established in 1980.[6] At present, under Part 1 of the Canadian Payment Act ("CP Act"), the CPA objects are stated in s. 5(1) to:

> (a) establish and operate national systems for the clearing and settlement of payments and other arrangements for the making or exchange of payments;
>
> (b) facilitate the interaction of its clearing and settlement systems and related arrangements with other systems or arrangements involved in the exchange, clearing or settlement of payments; and
>
> (c) facilitate the development of new payment methods and technologies.

In pursuing its objects, The CPA is mandated under Section 5(2) to "promote the efficiency, safety and soundness of its clearing and settlement systems and take into account the interests of users".[7]

Previously, Section 5 of the original Act stated that "The objects of the Association are to establish and operate a national clearings and settlements system and to plan the evolution of the national payments system."[8]

At present, and effectively as in the original statute quoted immediately above, the CP Act speaks in s. 5(1)(a) of the establishment and operation of "national systems for the clearing and settlement of payments"[9] run by it. Hence, there may be more than one "national system" established and operated by the CPA. Moreover, in entrusting in the CPA's hands the objective of facilitating "the interaction of its clearing and settlement systems and related arrangements with other systems or arrangements involved in the exchange, clearing or settlement of payments," s. 5(1)(b) envisages the existence of such other systems and does not appear to preclude them from being of national scope.

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[6] For a comprehensive discussion on the CPA see. e.g. Bradley Crawford, *The Law of Banking and Payment in Canada* vol 1 looseleaf (Aurora, ON: Canada Law Book, 2008 - 2014), Chapter 6.

[7] Under CP Act s. 2(1), "user" is defined to mean in Part 1, "a person who is a user of payment services but is not a member"

[8] Stat. Can. 1980-81-82-83, c. 40, s. 58.

[9] *CP Act*, *supra* note 3, s. 5(1)(a).

Indeed, in section 5(1), it is only sub-paragraph (a) that refers to national systems. Even then, the full power under s. 5(1)(a) is to "establish and operate national systems for the clearing and settlement of payments and *other arrangements for the making or exchange of payments*";[10] hence the power is not limited to "national systems." Hence both national and non-national systems can be run by either the CPA or someone else. At the same time, under s. 5(2), the CPA is required to "promote the efficiency, safety and soundness" only of "its [own] clearing and settlement systems" and not those operated by others. Strictly speaking, this requirement is not stated to relate even to "other arrangements for the making or exchange of payments" established and operated by the CPA under s. 5(1)(a)!

Subsections (b) and (c) of s. 5(1) do not even mention "national systems". Rather, they provide the CPA with powers in relation to "other systems or arrangements" as well as to "new methods and technologies"- not necessarily of national scope or impact.[11]

The CPA currently operates three "national systems for the clearing and settlement of payments":

- <u>Automated Clearing Settlement System</u> ("ACSS") — the "retail" system through which the majority of payments in Canada are cleared. Both paper cheques and electronic payment items are processed through this system.[12]

- <u>US Dollar Bulk Exchange</u> — a parallel system to the ACSS, used for clearing payments in US dollars.

- <u>Large Value Transfer System</u> ("LVTS") — the "wholesale" system through which financial institutions transfer large value payments in Canada.

Card networks are not operated by the CPA. Rather, credit card systems are operated by Visa and MasterCard. A national debit card network is run by Interac Association. This is an organization linking enterprises that have proprietary networks so that they may communicate with each other for the purpose of exchanging electronic financial transactions. At the moment, it is a cooperative. There is no national network for prepaid products, digital wallets, non-bank electronic funds transfers, and virtual/crypto currencies.[13] However, interbank settlement of all such networks takes

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[10] *CP Act*, *supra* note 3, s. 5(1)(a) [emphasis added].

[11] *CP Act*, *supra* note 3, s. 5(1).

[12] In principle (albeit subject to exceptions) such items must be drawn on a member and payable on demand. See Division 3 of Canadian Payments Association By-law No. 3 — Payment Items and Automated Clearing Settlement System SOR/2003-346. Eligible items are specified in CPA Rule A1 – General Rules Pertaining to Items Acceptable for Exchange, for the Purpose of Clearing and Settlement..

[13] Examples of retail payment methods are listed in Annex 1 of Department of Finance of Canada, *Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper* (released on April 13, 2015 and available online at http://www.fin.gc.ca/activty/consult/onps-ssnp-eng.asp) ("*Balancing Oversight Discussion Paper*")

part via the ACSS. As a rule, particularly debit and credit cards use the EMV technology so that payment instructions are authenticated by PIN rather than a manual signature. Contactless payments may be made by NFC credit cards. There are arrangements under which card information is loaded on mobile devices used to make card proximity payments using NFC technology. This is particularly true for credit and prepaid cards.

In fact, the CPA is not mandated to establish and operate "payment systems". Prima facie, the object to "establish and operate … other arrangements for the making or exchange of payments" under s. 5(1)(a) is ambiguous. However, in my view, as a whole, along the lines of the definition of "clearing and settlement system" under PCSA s. 2 discussed in this paper above in Part III, "national systems for the clearing and settlement of payments and other arrangements for the making or exchange of payments" under CP Act s. 5(1)(a) are to be limited to the interbank or inter-member domain, under which payment items or instructions are exchanged and paid. Conversely, while neither "system … for the clearing and settlement of payments" nor "payment system" is defined in CP Act Part 1, "payment system" is to be read more broadly as covering the entire operation of payment in monetary value from a payer to a payee using accounts and other arrangements with CPA members. It is enough of an enigma whether "other arrangements for the making or exchange of payments" under s. 5(1)(a) include the settlement of such payments; forcing the phrase to cover the entire payment transaction to be ultimately cleared and settled seems to me too far-fetched.

While under s. 5(2) the CPA is required "to take into account the interests of users", its mandate covers neither the customer-member domain nor the inter-customer (payer-payee) domain. However, under s. 5(1)(c), the CPA is mandated to "facilitate the development of new payment methods and technologies." This is narrower and less ambitious than the original corresponding mandate "to plan the evolution of the national payments system."[14] Nonetheless, it requires the CPA to address a broader scope in the payment transaction that that of the inter-member domain, namely that of clearing and settlement.

V. CP Act: CPA Membership

Section 4(1) of the CP Act provides that ,

(1) The Association shall consist of the following members:[15]

(a) the Bank of Canada;

(b) every bank;[16]

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[14] See *supra*, text & n. 8.

[15] Throughout this paper, unless the context requires otherwise, terms such as 'member', 'financial institution' or 'bank' may be used interchangeably.

[16] In this context, 'bank' means a chartered bank under Canadian federal legislation, i.e. Bank Act, SC 1991, c. 46.

(c) every authorized foreign bank; and

(d) any other person who is entitled under this Part to be a member and who, on application to the Association for membership in the Association, establishes entitlement to be a member.

Under Section 4(2) of the Act:

(2) Each of the following persons is entitled to be a member of the Association if they meet the requirements set out in the regulations and the by-laws:

(a) a central, a trust company, a loan company and any other person, other than a local that is a member of a central or a cooperative credit association, that accepts deposits transferable by order to a third party;

(b) [Repealed]

(c) Her Majesty in right of a province or an agent thereof, if Her Majesty in right of the province or the agent thereof accepts deposits transferable by order to a third party;

(d) a life insurance company;

(e) a securities dealer;

(f) a cooperative credit association;

(g) the trustee of a qualified trust; and

(h) a qualified corporation, on behalf of its money market mutual fund.[17]

At present, CPA members, as provided above, take part in the clearing carried out in the framework of the national payment system. At the same time, no licensing requirement exists for the provision of payment services.

Nowhere is it stated that *only* CPA members can provide payment services. In fact it is not even explicitly stated that CPA members may provide payment services! Rather, only CPA members may form and directly interface with the national clearing and settlement systems established and operated by the CPA, whether as Direct Clearers (having accounts with the Bank of Canada) or as Indirect Clearers (each having a correspondent relationship with a Direct Clearer acting as its agent).[18] Of

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[17] Categories set out in paragraphs (d), (g), and (h) were not included in the original Act. *Ibid*.

[18] See *Canadian Payments Association By-law No. 3 — Payment Items and Automated Clearing Settlement System*, S.O.R./2003-346, s. 1:

"direct clearer" means a member, other than the Bank of Canada, appointed under section 26 that, on its own behalf, exchanges payment items and makes entries into the ACSS.

"group clearer" means a member that, on its own behalf or on behalf of the entities belonging to the group in respect of which it is appointed in accordance with section 28, exchanges payment items and either effects clearing and settlement or makes entries into the ACSS.

course, this presupposes the provision by CPA members of payment services to customers. However, there is nothing to preclude a non-CPA member from providing payment services to customers as well. In practice, such a non-CPA member providing payment services will have an account with a CPA member, without which it is hard to envisage payment carried out outside this non-CPA member. At the same time, for merely providing payment service, no CPA membership is required.

In fact, other than in relation to anti-money laundering and anti-terrorist financing, [19] no form of regulation whatsoever is required for the provision of payment services. It is true that in the course of providing payment services a PSP may violate other regulatory requirements. For example, in Ontario, "[n]o person, other than a registered corporation, shall conduct, undertake or transact in … the business of borrowing money from the public by receiving deposits and lending or investing such money", unless this person is registered under the *Loan and Trust Corporation Act*.[20] Receiving a sum of money for transmission and using it until payment is made to the payee may easily fall within that prohibition. At the same time, as indicated, no requirements are set out for the mere provision of payment services.

Finally, payment system users are not eligible to become CPA members. However, as indicated above in Part IV, in pursuing its objects, the CPA is mandated under s. 5(2) to "take into account the interests of users". To that end, a Stakeholder Advisory Council "broadly representative of users and service providers to payment systems" is established under s. 21.2.

VI. CP Act: CPA Governance

Under CP Act s. 17,

> (1) The Board shall direct and manage the affairs of the Association and may for such purposes exercise all the powers of the Association.
>
> > (2) Subject to the by-laws, the Board may
> >
> > - (*a*) borrow money on the credit of the Association;
> > - (*b*) issue, reissue, sell or pledge debt obligations of the Association; and

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"indirect clearer" means a member on behalf of which a clearing agent exchanges payment items and either effects clearing and settlement or makes entries into the ACSS.

In this study "group clearers" are not distinguished from "direct clearers" and thus not specifically referred to.

[19] Under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act S.C. 2000, c. 17

[20] R.S.O. 1990, c. L.25, s. 213(1) in conjunction with the definition of "loan corporation" in s. 1.

- (*c*) mortgage, pledge or otherwise create a security interest in all or any property of the Association owned or subsequently acquired, to secure any obligation of the Association.

As will be seen below, under CP Act ss. 18-19.1 the Board is also has the power to issue by-laws, rules, and statement of principles.

At present, but subject to an amendment adopted but not proclaimed in force yet and discussed further below, under CP Act s. 8, the Board of Directors consists of sixteen persons elected or appointed as outlined in s. 9 set out below:

9. (1) The Bank of Canada shall appoint

- (*a*) an officer of the Bank to be a director of the Association; and
- (*b*) an officer of the Bank to be an alternate director to the director appointed under paragraph (*a*) and the alternate director so appointed may act as a director during any period in which the director for whom he or she is an alternate is, by reason of absence or incapacity, unable to act.

(1.1) The Minister shall appoint three directors of the Association to hold office for a term of not more than three years.

…

(2) Subject to subsection (3), twelve directors of the Association shall be elected by the members to hold office for a term of three years, except that of those first elected four shall be elected for a term of three years, four for a term of two years and four for a term of one year.

(3) For the purpose of election of directors, the members, other than the Bank of Canada, shall be grouped into seven classes,[21] namely,

- (*a*) banks, but excluding federal credit unions as defined in section 2 of the *Bank Act*, and authorized foreign banks;
- (*b*) centrals, cooperative credit associations and federal credit unions as defined in that section;
- (*c*) trust companies and loan companies;

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[21] Under CP Act s. 13(1),

Every member is entitled to vote for the directors representing the class to which the member belongs and may cast the number of votes that the member is entitled to cast, as determined by the regulations, multiplied by the number of directors of that class to be elected and the member may cast all such votes in favour of one candidate or distribute them among the candidates in any manner.

Under s. 3(1) of the Canadian Payments Association Election of Directors Regulations, SOR/2002-215 "the number of votes that a member is entitled to cast for the election of directors of its class equals one ten-thousandth of that member's payment items volume during the last completed fiscal year immediately preceding the election".

- (*d*) qualified corporations and trustees of qualified trusts;
- (*e*) securities dealers;
- (*f*) life insurance companies; and
- (*g*) other members.[22]

Under CP Act s. 16. (1),[23] the directors shall appoint the President of the Association.

> (2) The President is the chief executive of the Association and has, on behalf of the Board, the direction and management of the business of the Association with authority to act in all matters that are not by the by-laws or by resolution of the Board specifically reserved to be done by the Chairperson, the Board or the Executive Committee.

Under this governance structure, control of the CPA is by its members, as they elect 12 out of the 16 directors.

VII. CP Act: CPA By-Laws, Rules and Statements of Principle

The CPA carries out its objects by making by-laws, rules, and statements of principle and standards. Rules are subject to by-laws and statements of principles and standards are subject to by-laws and rules. All such norms must relate to any of the CPA objects.

The power to make <u>by-laws</u> is provided in Section 18(1) of the CPA Act, which authorizes the Board to make such by-laws designed for the attainment of the objects of the Association" including:

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[22] Under s. 4 of Canadian Payments Association Election of Directors Regulations, SOR/2002-215

The number of directors to be elected in respect of each of the classes established under subsection 9(3) of the Act is as follows:

(*a*) six directors shall be elected by the members of the class described in paragraph 9(3)(*a*) of the Act;

(*b*) two directors shall be elected by the members of the class described in paragraph 9(3)(*b*) of the Act; and

(*c*) a total of four directors shall be elected by the members of the following classes, in accordance with sections 5 and 6:

- (i) the class described in paragraph 9(3)(*c*) of the Act,
- (ii) the class described in paragraph 9(3)(*d*) of the Act,
- (iii) the class described in paragraph 9(3)(*e*) of the Act,
- (iv) the class described in paragraph 9(3)(*f*) of the Act, and
- (v) the class described in paragraph 9(3)(*g*) of the Act.

[23] Under an earlier version:

16. (1) The directors shall appoint a General Manager of the Association.

(2) The General Manager has, on behalf of the Board, the direction and management of the business of the Association with authority to act in all matters that are not by the by-laws or by resolution of the Board specifically reserved to be done by the Chairperson, the Board or the Executive Committee.

- (*b*) establishing, subject to this Part, requirements for membership in the Association;
- (*c*) for the administration and management of the business of the Association; …
- (*d*) respecting the exchange and clearing of payment items and related matters;
- (*e*) respecting settlements and related matters; …
- (*h*) respecting the authenticity and integrity of payment items and messages;
- (*i*) respecting the identification and authentication of members and other persons;

Under s. 18(2), and subject to specific requirements as to a by-law establishing penalties,[24] "a by-law is not effective until approved by the Minister and when so approved must be published in the *Canada Gazette* and copies of the by-law must be sent to every member by the President."[25]

The <u>Rule</u> making power of the Board is provided in Section 19(1) which subject to by-laws, authorizes the Board to make such rules designed for the attainment of the objects of the Association, particularly,

> (a) respecting payment items acceptable for exchange, clearing or settlement;
>
> (b) establishing standards and procedures in respect of the exchange and clearing of payment items;
>
> (c) respecting settlements and related matters;
>
> (d) respecting the authenticity and integrity of payment items and messages; and
>
> (e) respecting the identification and authentication of members and other persons.

The power to issue <u>statements of principle and standards</u> is provided in Section 19.1, under which subject to the by-laws and rules, the Board is authorized to "make such statements of principle and standards" designed for the attainment of the objects of the Association.

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[24] These requirements are set out in s. 18 as follows:

(3) A by-law establishing a penalty shall not be submitted to the Minister for approval until it has been submitted for approval to the members and approved by them at a meeting of members.

(4) Every member is entitled, on a resolution to approve a by-law establishing a penalty, to one vote for each dollar that the member is required to contribute as dues under the by-laws.

[25] As well, "by-laws … are statutory instruments… which means that they must be approved by the Department of Justice." Crawford, supra note ??? at 6:10.10(1) treating the CPA as a 'quasi-public institution'.

The CPA must advise the Minister of Finance of any proposed rules, and the Minister may disallow any rule (Section 19.2(3)). As well, under Section 19.3, and subject to consultation, if the Minister is of the opinion that it is in the public interest to do so, the Minister may, in writing, direct the Association to make, amend or repeal a by-law, rule or standard.

VIII. Task Force Legislative Reform Proposal

As indicated above in Part I, the Task Force recommended the passage of legislation designed to radically reform the governance of the Canadian national payment system. Such legislation would:

(i) define a discrete payments industry;

(ii) create a public oversight body to ensure effective governance of the industry;

(iii) encourage the creation of self-governing body to develop and implement strategy and standards for the payments system; and

(iv) amend the Canadian Payments Act by overhauling the governance, business model and powers of the Canadian Payments Association .

The Task Force proposed that, to achieve this, the government ought to introduce legislation to accomplish the proposal outlined below:

1. *Define a discrete payments industry, establish the basis on which its members would be recognized and establish the principles and objectives of the new governance model.*

The Task Force identified the need to broaden the scope of entities that are regulated. To accomplish this, the Task Force suggested that the function an entity performs should be the criteria for subjecting the entity to regulation. A “payment service provider” would be defined broadly as one that facilitates the transfer of monetary value from one party to another. In an attempt to narrow the scope of such a broad definition, the Task Force proposed that how directly a firm’s activities relate to this function is what will determine whether it is a payment service provider for purposes of the legislation.

The Task Force’s Regulatory Advisory Group suggested that:

- Traditional financial institutions, network operators, credit and debit card issuers and acquirers should be included in the new regime, as will new participants such as online payment networks.
- Issuers of financial cards for services offered only through their own retail outlets would not be included unless there was a large enough secondary market for their cards to give them general purchasing power.

- Parties that conduct payment services as independent contractors, or as agents for payment services providers, will generally not be required to be members; however, they will probably find voluntary membership valuable.

In an example of how directly an entity's activities relate to facilitating the transfer of value, the Task Force observed that a network operator that sets rules for its payment system is clearly a more direct facilitator than a telecommunications company that merely supplies the technical means by which the payment information is transferred[26]. Similarly, in a table of various payments participants, the Regulatory Advisory Group listed telecommunications firms under the heading "Users and other stakeholders", and described their status within the scope of new payments legislation as "Optional (unless providing a payment service as per above)"[27].

Specifically the Task Force proposed on this point:

- ❑ Mandatory membership for payment systems providers including banks, other financial institutions, other payment service providers, networks, software suppliers, processors and acquirers
- ❑ Optional membership to payment system users including consumers and merchants.

Arguably, however, a narrower category of "Payment Service Provider"- or PSP -- ought to be set aside for particular treatment. Only those who deal directly with the public, namely with payers and payees, should be considered as 'payment service providers.' Those employed by them, such as their processors, should be at the employer's responsibility. Stated otherwise, the employer ought to be taken as having outsourced a function. As for those entities dealing with the public, particular attention is to be given to those who take money for from the public and hold it as money transmitters, issuers of prepaid cards, or issuers of electronic money. They are to be distinguished, for example, from money changers, who deal with money, and yet at no point hold money for their customers. A much lighter, if any form of regulation is to apply to the latter. Stated otherwise, 'payment services' is a narrower category than both 'money services'[28] and payment industry services.[29]

Thus, in the footsteps of Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market ("PSD"),[30]

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[26] Task Force for the Payments System Review, Policy Paper C: Legislation - Establishing the Payments Industry, December 2011, p. 6.

[27] *Ibid.*, at para. 47.

[28] The latter is the broader category covered in the United States by the Uniform Money Services Act (UMSA) which covers business and services offering currency exchange, money and wire transfers, and cheque cashing services.

[29] For the latter, see e.g. CPMI, *Non-banks in retail payments* (Basle, BIS, September 2014)

[30] OJ, L 319/1, 5.12. 2007.

"payment services" are limited to withdrawals, deposits, execution of payment transactions and remittances. In effect, a payment service provider is a person that holds or receives funds from the payer for carrying out payment to the payee, as well as the person who is put with such funds at the end of the payment transaction to make them available to the payee. Other than deposit takers, the PSD provides for the licensing of "payment institutions" authorized to provide payment services. The PSD Preamble explains the rationale for this as follows:[31]

> The conditions for granting and maintaining authorisation as payment institutions should include prudential requirements proportionate to the operational and financial risks faced by such bodies in the course of their business. In this connection, there is a need for a sound regime of initial capital combined with ongoing capital … The requirements for the payment institutions should reflect the fact that payment institutions engage in more specialised and limited activities, thus generating risks that are narrower and easier to monitor and control than those that arise across the broader spectrum of activities of [deposit-taking] ... institutions. In particular, payment institutions should be prohibited from accepting deposits from users and permitted to use funds received from users only for rendering payment services. Provision should be made for client funds to be kept separate from the payment institution's funds for other business activities. Payment institutions should also be made subject to effective anti-money laundering and anti-terrorist financing requirements.

Indeed, the regulation, supervision and oversight over PSPs which do not qualify to become CPA members, and/or are not regulated otherwise, is a gap to be addressed by policy makers in Canada.[32] This is a matter of both (i) the creation of a playing level field for all payment service providers, and (ii) the provision of protection to the public. Indeed, players such as money transmitters, issuers of prepaid cards, and electronic-money issuers, do not take deposits in order to lend them in their own name. At the same time, they do hold funds of the public, albeit even only for a short time. Furthermore, they should be allowed to put funds given to them in safe short-term investment, if only to thereby allow for the reduction of fees for their services. Hence, there is a strong public interest in seeing that these funds are securely kept. For all these reasons they ought to be subject to some form regulation, albeit certainly, not as heavy as that to which banks and other deposit taking institutions are subject.

This is not to say that network operators and clearing houses, side by side with other payment industry service providers, such as processors, and equipment and software manufacturers and vendors, should be regulation-free. At the same time, their membership or participation in a SGO, further outlined immediately below, should be carefully considered, with the view of avoiding adversely affecting the effectiveness of such an organization, so as not to turn it into a mere forum for discussions and the exchange of views.

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[31] *Ibid*., preamble (11).

[32] A point acknowledged in *Balancing Oversight Consultation Paper*, note 13 *supra*.

2. *Create a new public oversight body (POB) for the Canadian payments system to protect the public interest.*

In protecting the public interest, through an approach based on the principles of trust, access and good value, the POB would assess the level of risk, competition and innovation in the payments system; ensure that it continues to meet the public interest by providing effective access to the payments system for all Canadians; and recognize and oversee a self-governing organization (SGO) for the payments system.

Under its power to recognize the SGO, the POB would delegate much of its regulatory mandate to the SGO, while maintaining directive power over it. Specifically, the POB would review and approve any important SGO and Canadian Payments Association (CPA) membership policies and operational processes, as well as any SGO codes of conduct, policies and standards or CPA rules that could reasonably affect the public interest. In this context, the POB should be able to:

- ❑ Provide guidance, where necessary, when industry cannot agree on a solution and provide a recourse process for unresolved conflicts at the SGO

- ❑ Take action if private sector behavior is no longer consistent with the public interest as determined by the legislation

3. *Encourage industry to create a broad-based and collaborative association to serve as the SGO to develop and implement strategy and standards for the payments system.*

The SGO comprises two groups of members: recognized participants in the payments industry, whose membership would be mandatory; and payment system users, whose membership would be voluntary.

While the POB and the private sector would ultimately determine the mandate and form of the SGO, in the Task Force's proposed model, the SGO would set the strategic direction for the payments industry in Canada and facilitate competition and innovation; develop and enforce industry-wide policies and standards; ensure that appropriate safeguards exist with respect to the soundness and integrity of the payments system and services; and lead industry efforts to promote interoperability with foreign payments systems, and cooperation among payments and other industries regarding common technologies (e.g., digital identification and authentication).

4. *Reinvent the objects, governance, powers and business models of the CPA through legislation and oversight from the POB.*

The CPA owns and operates much of the core infrastructure that is vital to the payment system, and is currently the only body in Canada focused on its operations and governance . In its review of the current infrastructure regime, the Task Force was of the opinion that the fundamental principles of trust, access and good value are not currently being upheld and, as key systems are aging, investments to develop the concept of immediate funds transfer (IFT) are not being made at the CPA.[33]

A reformed CPA would operate in the public interest by providing a safe core infrastructure for retail and wholesale payments clearing and settlement that maintains the trust of Canadians; operating a cost-efficient payments infrastructure that provides enough competitive space to allow payment service providers to differentiate themselves; developing through a consultative process a strategic business plan to innovate its networks in response to stakeholders needs and market opportunities; and allowing open access to its networks for qualified participants to bolster competition.

The proposed reformed CPA would be transformed into a core infrastructure entity and become a non-share capital corporation with no shareholders. Participants would include payment service providers who qualify for access, but would not have a vote in decision making. The reformed CPA would have measureable objectives to ensure the CPA is meeting its mandate; access to debt financing and power to charge fees based on full cost recovery; and be possessed with the flexibility to acquire and divest related businesses and setting objectives and transparent minimum criteria for new entrants and direct clearers.

Decision-making power would be vested solely in the board, which would have a fiduciary duty to the interests of the CPA and be chosen through a nomination process outlined in the legislation. To ensure stakeholder input, the Task Force recommended the board be composed of three federal government appointees, three participant appointees and three independents. In addition, the Bank of Canada would sit on the board in an observer capacity.

IX. Actual Payment System Reform: CPA Governance

Actual reform steps taken so far have been substantially more modest. No 'discrete payment industry' has been defined. Neither POB nor SGO has been established. No change in the powers of the CPA has been introduced. Rater, a substantial modification in the CPA governance was legislated,[34] albeit is not in force yet.

The changes affect the Board of Directors and introduce a new accountability framework. The can be summarized as follows:

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[33] For such systems see: BJ Summers and KE Wells, "Emergence of immediate funds transfer as a general –purpose means of payment", Federal Reserve Bank of Chicago, 3Q/2011, Economic Perspectives, 97-112.

[34] 2014, c. 39, ss. 334-357

1. Changes to the Board of Directors:

- Create a smaller, majority independent Board of Directors, reducing its size from 16 to 13 members;
- Neither the Bank of Canada nor Ministerial appointees will sit on the Board;
- Two classes of directors would be elected by all CPA members:
    - 7 independent directors; and,
    - 5 member directors, three of whom must be direct clearers;
- The President of the CPA would become a member of the Board; and
- The chairperson and deputy chair of the Board would be selected from among the independent directors;

2. New Accountability Framework:

- The Board would submit a five-year corporate plan annually to the Minister of Finance for approval;
- The Board would publish an annual report, including audited statements and a report from the Chairperson of the Stakeholder Advisory Council;
- The Board would have authority for approving the operating and capital budgets of the Association; and,
- The Minister of Finance's directive power would be expanded to issue directives to the CPA in any instance where the Minister deems it to be in the public interest to do so.

3. Miscellaneous:

- A new Members Advisory Council would be established to advise the Board on technical and operational aspects associated with the operation of CPA systems and the development of new technologies; and,
- Votes on matters to be decided by CPA members would occur on a one-member, one-vote basis.

Undoubtedly, the most significant change is the installation of a majority independent Board of Directors.[35] This purports to turn the CPA into an independent organization, not controlled by its own members.

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[35] On March 21, 2015, the Government of Canada proposed a regulation under the CP Act to establish criteria for selecting independent directors of the CPA in accordance with conflict-of-interest principles. The regulation would also provide balanced representation on the Association's Board of Directors for the largest users of and contributors to the Canadian payments system. *Canadian Payments Association Election of Directors Regulations*, Canada Gazette Part I (March 21, 2015).

Accordingly, once in force, a replacing s. 8 states in part the following:

> (1) There shall be a Board of Directors of the Association consisting of the following 13 directors:
>
> - (*a*) the President;
> - (*b*) three directors who are directors, officers or employees of members that, in the normal course of business, maintain a settlement account at the Bank of Canada;
> - (*c*) two directors who are directors, officers or employees of members other than those described in paragraph (*b*); and
> - (*d*) seven directors who are independent of the Association and of its members.
>
> (2) The directors referred to in paragraphs (1)(*b*) to (*d*) are to be elected[36] by the members.

Once in force, a replacing s. 16(1) provides that the President will be appointed by the elected directors (in fact, all directors other than the President).

As well, under s. 9,

> (1) No person is eligible to be a director if they are
>
> - (*a*) a director, officer or employee of the Bank of Canada;
> - (*b*) employed in any capacity in the federal public administration or the public service of a province or hold any office or position for which any salary or other remuneration is payable out of public moneys; or
> - (*c*) a member of the Senate or House of Commons or a member of a provincial legislature.
>
> (2) When a director, officer or employee of a member is a director of the Association, no other director, officer or employee of that member, or of an affiliate of that member, is eligible to be a director of the Association.

Once in force, a new 16.1 fastens on CPA directors and officers duties to act in good faith and exercise due care.

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[36] Under (once in force) a new s. 4.1(1) "Each member shall have one vote on all matters to be decided by members."

Presumably in recognition of the fact that independent directors, coming from other than members, may lack the skills in payment system operational matters, once in force, a new s. 21.4(1) establishes a new body, as follows:

- 21.4 (1) There shall be a Member Advisory Council consisting of persons appointed by the Board.

  (2) The object of the Council is to provide counsel and advice to the Board on the Association's operation of clearing and settlement systems, the interaction of those systems with other systems involved in the exchange, clearing or settlement of payments and the development of new technologies.

  (3) The Council shall be broadly representative of the diversity of the membership of the Association.

Once in force, the new legislation varies only slightly the Minister of Finance's control over the norm-issue power of the Board. However, it expands the Minister's control on other actions taken by the CPA. For now, as discussed above in Part VII, in principle, by-laws require Ministerial approval (Section 18(2)). As well, the CPA must advise the Minister of Finance of any proposed rules, and the Minister may disallow any rule (Section 19.2(3)). Also, under Section 19.3, and subject to consultation, if the Minister is of the opinion that it is in the public interest to do so, the Minister may, in writing, direct the Association to make, amend or repeal a by-law, rule or standard.

Once in force, a replacing s. 18(2) states that other than in matters respecting the composition of the Stakeholder Advisory Council, a by-law "shall not come into force unless it is approved by the Minister …" Under a replacing s. 19.3(1), where "the Minister is of the opinion that it is in the public interest to do so," the Minister may issue a written directive to the CPA, including, but unlike now, not only, "a directive to make, amend or repeal a by-law, rule or standard."

Specific requirements regarding by-laws establishing penalties are repealed. In principle, there is no change in the Minister's power to disallow norms. An exception is provided by a replacing s. 19.3(2). Thereunder, a norm-disallowing directive relating to the operation of a clearing and settlement system designated under subsection 4(1) of the Payment Clearing and Settlement Act is specifically required to be made by the Minister after consultation with the Governor of the Bank of Canada. Interestingly, in originally issuing a norm affected the operation of such a clearing and settlement system, the CPA Board itself is not required to consult the Governor of the Bank of Canada.

New accountability framework is provided by replacing Sections 22-24. Once in force they require and govern operating and capital budgets as well as a corporate plan and annual report to be issued by the Board. Related to accountability is also a new s. 49. Once in force it requires a Ministerial review of the Act and its operation three years after the day on which this section comes into force.

X. CP Act Part 2: Designation of a National Payment System

CP Act Part 2, consisting of Sections 36-42, does not apply to the CPA (CP Act s. 36.2). Under CP Act s. 37(1), the Minister of Finance has the power to "designate" a payment system, thereby bringing it under the Minister's authority. To date, the Minister has not exercised this power. In order to designate a payment system, the Minister must consider that it is in the public interest to do so, and the payment system must be national or substantially national in scope, or play a major role in supporting transactions in Canadian financial markets or the Canadian economy. Under CP Act s. 37(2), the Minister is required to consider the following factors in determining whether it is in the public interest to designate a payment system:

> (a) the level of financial safety provided by the payment system to the participants and users;
> (b) the efficiency and competitiveness of payment systems in Canada; and
> (c) the best interests of the financial system in Canada.

Under Section 36, "payment system" is defined to mean,

> a system or arrangement for the exchange of messages effecting, ordering, enabling or facilitating the making of payments or transfers of value.

Once a system is designated, the Minister of Finance is authorized to require information and to issue directives and guidelines. Thus, under CP Act, Section 40(1), and following consultations,

> The Minister may issue a written directive to the manager or a participant of a designated payment system in respect of
> (a) the conditions a person must meet to become a participant in the designated payment system;
> (b) the operation of the designated payment system;
> (c) the interaction of the designated payment system with other payment systems; or
> (d) the relationship of the designated payment system with users.

As well, under Section 40(3),

> The Minister may specify in a directive that a manager of a designated payment system or a participant shall, within such time as the Minister considers necessary,
> (a) cease or refrain from engaging in an act or course of conduct;
> (b) perform such acts as in the opinion of the Minister are necessary in the public interest; or
> (c) make, amend or repeal a rule.

“Participant” is defined in Section 36 to mean:

> a party to an arrangement in respect of a payment system.

The latter definition is unfortunate or at least awkward . As just indicated, “payment system,” as defined in s. 36, may be constituted by “a system *or* arrangement” (emphasis added) and hence it is not all that obvious which is the “arrangement in respect to a payment system” to which a “participant” is required to be a party. At any rate, ‘participant’ is to be distinguished from “user”, defined in CP Act s. 2(1) to mean in Part 2 to be “a person who is a user of services provided by a participant of a payment system but is not a participant in the system.” “Participants” are thus PSPs and “users” are their customers. namely, payers or payees. This however creates a problem in the interpretation of CP Act s. 40(1)(d) reproduced immediately above. The latter address “the relationship of the designated payment system with users.” However, the “system” is more likely to have relationships with ‘participants’ and not ‘users’, who are in relationship with ‘participants.’

The reference to a participant being a party to an arrangement suggests that participants are in contractual relations with one another, and thus a reasonable interpretation is also that participants will be members of the payment system. It does not mean however that as such they are necessarily in control of it. What is missing then is a reference to the system’s clearing house – as distinguished from its participants and manager – for which the Minister is not given an explicit authority.

XI. Reconciliation among BOC’s Powers under PCSA, CPA’s Powers under CP Act, and the Minister’s Powers under CP Act

This Part addresses the relationship among three related terms and the ensuing divisions of statutory powers. The terms are (i) “payment system” dealt with in CP Act Part 2, (ii) “systems for the clearing and settlement of payments” under CP Act Part I, and (iii) “clearing and settlement system” governed by the PCSA. These three terms are respectively discussed in this paper above in Parts X, IV and III and are central to the division of the responsibilities among the Minister of Finance, the CPA, and the BOC respectively. Among these three terms, only the second, that of a “systems for the clearing and settlement of payments” (CP Act Part1) is undefined. However, in principle, it should be taken to mean substantially the same as the third (PCSA).[37] Along lines discussed above in Part IV, both the second and third terms must be taken to relate to the interbank or inter-member domain which is part of the payment process and yet not its entirety. This is in contrast to the first term, “payment system” governed by CP Act Part 2, which ought to be read as covering the entire operation of payment in monetary value from a payer to a payee.

[37] The full definition of “clearing and settlement system” under PCSA s. 2 is reproduced above in Part III. Prima facie, some limitations under that definition, such as relating to a Canadian participant and Canadian dollar, need not necessarily apply to “systems for the clearing and settlement of payments” under CP Act Part 1.

Since the inter-bank clearing and settlement domain is part of the transfer of monetary value carried out by a payment system the potential for an overlap of powers appears to arise. A possible way to reconcile the powers among the three statutory sets of provision is to focus on the risk addressed by each authority. Accordingly, under CP Act Part1, the CPA is mandated to address "the efficiency, safety and soundness of its clearing and settlement systems and take into account the interests of users."[38] The PCSA mandates the BOC and its Governor to address "payment risks" and "systemic risk".[39]

For its part, CP Part 2 requires the Minister of Finance to watch for

> (a) the level of financial safety provided by the payment system to the participants and users;
>
> (b) the efficiency and competitiveness of payment systems in Canada; and
>
> (c) the best interests of the financial system in Canada."

However, "payment system risk" is defined in PCSA s. 2 to mean

> the risk that a disruption to or a failure of a clearing and settlement system could cause a significant adverse effect on economic activity in Canada by
>
> > (*a*) impairing the ability of individuals, businesses or government entities to make payments, or
> >
> > (*b*) producing a general loss of confidence in the overall Canadian payments system, which includes payment instruments, infrastructure, organizations, market arrangements and legal frameworks that allow for the transfer of monetary value.

Even without a painstaking word-by-word analysis it is thus obvious that only "systemic risk" may not raise significant overlap issues. The latter is defined in PCSA s. 2 to mean

> the risk that the inability of a participant to meet its obligations in a clearing and settlement system as they become due, or a disruption to or a failure of a clearing and settlement system, could, by transmitting financial problems through the system, cause
>
> > (*a*) other participants in the clearing and settlement system to be unable to meet their obligations as they become due,
> >
> > (*b*) financial institutions in other parts of the Canadian financial system to be unable to meet their obligations as they become due,

[38] See CP Act s. 5(2) and discussion in Part ??? above.

[39] PCSA s. 4(1) and discussion in Part III above.

(*c*) the clearing and settlement system's clearing house or the clearing house of another clearing and settlement system within the Canadian financial system to be unable to meet its obligations as they become due, or

(*d*) an adverse effect on the stability or integrity of the Canadian financial system.[40]

Alternatively, reconciliation may be made by limiting the BOC power (under the PCSA), other than in connection with "systemic risk", to oversight and that of the Minister of Finance (under CP Act Part 2) to the bank-customer payer-payee domains. The problem with this interpretation is that the measures that may be taken by the Minister under CP Act Part 2, set out above in Part X, focus on the inter-participant domain – and not on the relationship between a participant and its customer. This is not to deny the Federal Government's power to legislate and regulate customers' rights in payment transactions; it is only to say that this power emanates neither from the CP Act nor from the PCSA.

Or else, CP Act Part 2 may be taken to address both national payment systems not operated by the CPA -- as well as those operated by the CPA, but that nevertheless specifically set aside and designated to be subject to a greater scrutiny. Such greater scrutiny becomes available due to the broader powers given to the Minister (under CP Part 2) than those given to the CPA (under CP Act Part 1).

In its recent consultation document, i.e. The *Balancing Oversight Discussion Paper*,[41] the Government of Canada pointed out that under CP Act Part 2 the Government "has responsibilities with respect to the oversight and regulation of payment systems that are national or substantially national in scope, or systems that play a major role in supporting transactions in Canadian financial markets or the Canadian economy." To that end it "has developed an oversight framework in which each system is assigned a place along a continuum according to the overall level of risk it poses to the economy."[42] Systems were divided to three categories:

(i) national retail payment systems processing low-value payments such as card networks and online payment systems;

[40] For both "payment system risk" and "systemic risk" under the PCSA see discussion in Part III above.

[41] Note 13, *supra*.

[42] *Balancing Oversight Consultation Paper*, *supra* note 13 at 5.

(ii) prominent payment systems such as the ACSS, and

(iii) systematically important systems (such as the LVTS).[43]

According to that paradigm, oversight relating to safety and soundness is the strictest on the third (systematically important systems) and lightest on the first (national retail systems). Conversely, in relation to user protection, the increasing weight on user protection is from the systematically important systems (the strictest oversight) to the national retail payment systems (the lightest oversight). For its part, the public policy of efficiency would apply across the spectrum.

The *Balancing Oversight Discussion Paper* enumerated in its Annex 3 three objectives to be met by the regulation and oversight of the Canadian payment system. These are safety and soundness, efficiency and meeting the needs of Canadians, defined to include consumers, business and governments, as well as participants and entities operating a payments system. However, division of responsibilities is neither by statute nor by authority. Rather, each authority is expected to adhere to these objectives in carrying out its own tasks.

Possibly then, and notwithstanding the fact that this aspect is not addressed by the consultation paper, the following division of powers may exist:

• BOC's powers under the PCSA apply to both the systematically important and prominent systems. In fact, in principle, they exist also for retail systems. In fact, it is the absence of a risk, and not system's a-priori classification, which precludes a system from becoming subject to the BOC's powers, but not before risk absence with respect to it is determined by the BOC.

• The Minister of Finance's powers under CP Act Part2 then focus on national retail payment systems but also exist for both prominent and systematically important systems – to the extent that such powers do not collide with those of the BOC under the PCSA.

• The CPA's powers under CP Act Part 1 are available for both prominent and systematically important systems – albeit subject to the powers of both the BOC and the Minister of Finance under the PCSA and the CP Act Part 2. In fact, the Minister's powers for systems established and operated by the CPA are not only under the CP Act Part 2 but also, in relation to CPA's norms, under CP Act Part 1.

In the final analysis, the CPA is not a regulator; rather it is an association entrusted with the establishment and operation of clearing and settlement systems. In fulfilling its mandate, it is required to comply with specified standards, albeit, subject to regulation and oversight by the BOC and the Minister of Finance. This is notwithstanding the autonomy given to the CPA in running its affairs.

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[43] For systems in Canada see above in Part IV.

A final issue is with respect to the CPA's object under CP Act (Part 1) s. 5(1)(c). This object confers on the CPA the power is to "facilitate the development of new payment methods and technologies."[44] While this is does not specifically in any contradiction with the Minister's powers under CP Part 2, this power remains an outlier for an organization whose principal powers are limited to the interbank domain.

XII. Payment Card Network Act (PCNA)

The third statute relating to the operation of the national payment system in Canada is the *PCNA*. It addresses the bilateral position of a network card operator with the issuer as well as with the acquirer, i.e, with system participants. It is the primary legislation governing payment card networks in Canada.

The purpose of the *PCNA* is stated to be the regulation of national (retail) payment card networks and the commercial practices of payment card network operators.[45] However, its operative provisions do not contain any requirement as to the "national" feature of the card network to fall within its ambit.

Section 3 of the Act sets out the definitions of three key terms:

> "Payment card" means a credit or debit card — or any other prescribed device — used to access a credit or debit account on terms specified by the issuer. It does not include a credit card issued for use only with the merchants identified on the card.
>
> "payment card network" means an electronic payment system — other than a prescribed payment system — used to accept, transmit or process transactions made by payment card for money, goods or services and to transfer information and funds among issuers, acquirers, merchants and payment card users.[46]
>
> "payment card network operator" means an entity that operates or manages a payment card network, including by establishing standards and procedures for the acceptance, transmission or processing of payment transactions and by facilitating the electronic transfer of information and funds.[47]

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[44] Discussed above in this paper above in Part IV.

[45] *PCNA*, *supra* note 4, s. 2.

[46] *Ibid*. at s. 3.

[47] *Ibid*.

Here are a few points regarding these definitions:

1. I suppose "transactions made by payment card" include those transactions made by communicating card information (the so-called 'car-not-present' or CNP);

2. "Payment card operator" is broad enough to include the network association (such as Visa or MasterCard) and a processor for the network;

3. While the definitional framework focuses on "cards", "card" is broadly defined to include "any … prescribed device". This confers a very broad, in fact unfettered, discretion on the regulator (per s. 6 set out below)[48] as to the payment instruments to be brought within the ambit of the *PCNA*.

The *PCNA* gives the Financial Consumer Agency of Canada, established under s. 3 of the *Financial Consumer Agency of Canada Act*,[49] the mandate to supervise the payment card network operators to determine whether they are in compliance with the provisions of the *PCNA* and the regulations.[50]

Section 6 of the *PCNA* also provides that the Governor in Council may, on the recommendation of the Minister, make regulations:

(a) respecting payment card networks;

(b) specifying the types of rates that a payment card network operator must disclose and the manner in which the disclosure must be made;

(c) prescribing the time and manner in which a payment card network operator must give notice of any new rates or any changes in its rates or fee schedules, as well as to whom the notice must be given;

(d) prescribing conditions regarding the issuance of payment cards that a payment card network operator must include in any agreement entered into with an issuer;

[48] See particularly *PCNA*, *supra* note 4, s. 6(f), under which it is the Governor in Council on the recommendation of the Minister who has the power to prescribe "anything that by this Act is to be prescribed".

[49] S.C. 2001, c. 9 [*FCACA*].

[50] *PCNA*, *supra* note 4, s. 5.

(e) prescribing conditions that a payment card network operator must include in any agreement entered into with an acquirer;

(f) prescribing anything that by the *PCNA* is to be prescribed; and

(g) generally for carrying out the purposes and provisions of the *PCNA*.[51]

The *PCNA* also states that a payment card network operator that is a party to an agreement containing any of the conditions required by regulations described in s. 6(d) to (e) must take reasonable measures to enforce those conditions.[52]

In its scope, the *PCNA* is limited to the relationship between the network operator and network participants, whether they are issuers or acquirers. It is, however, obvious that some of what is either agreed by, or regulated for, acquirers and issuers in their relationships with the network operator will affect terms to be agreed by acquirers and issuers with their customers, namely, merchants and cardholders.

To date, no regulations have been enacted by the Governor in Council. This appears to reflect a conscious psreference by the Federal Government of codes of conduct reflecting industry consensus reached under the auspices of the government. According to para. 4.3 of the *Balancing Oversight Discussion Paper*,[53]

> codes of conduct may be better tools for addressing market conduct risk, as they are more flexible than legislation and can be adapted more easily to evolving user needs and fast-paced technological innovations, such as those seen in the retail payments sector. Generally, codes of conduct also benefit from more industry collaboration and favour the spirit of the rules, as opposed to the letter of the law

Citing the *Canadian Code of Practice for Consumer Debit Card Services* and the *Code of Conduct for the Credit and Debit Card Industry in Canada*, as examples of codes that apply to retail payment systems and have been effective in addressing market conduct and consumer protection issues, the *Balancing Oversight Consultation Paper* goes on to acknowledge that nevertheless “sometimes voluntary codes need to be supported by legislation to strengthen adherence and compliance.” The former code covers the issuer-cardholder relationship while the latter focuses on the relationship between the merchant and acquirer. At the same time, the effect of the regulatory powers created by the *PCNA* cannot be known until the implementing regulations are promulgated.

[51] *Ibid*. at s. 6.

[52] *Ibid*. at s. 7.

[53] Note 13, *supra*.

XIV. Conclusion and Final Observations

In addressing the Final Report of the Task force for the Payment System Review, discussed above in Parts I and VIII, Bradley Crawford observed that "[t]he most significant achievement of the Report is the breadth of its vision."[54] However, while the final report is visionary and contains many elements that should be seriously considered, its implementation may be difficult given that the recommendations require the cooperation of a variety of participants, including those that the Task Force suggested had delayed future development in the past.

As well, focusing on retail payments, the Final Report does not address the overall picture which includes the wholesale/large-value payments. This omission entailed a bigger one, which is the omission to address the role of the BOC in the overall payment system regulatory and governance scheme. Having overlooked such an important player, the Final Report fails to sketch a complete and comprehensive scheme of regulatory responsibility, its distribution among the various contenders, and the hierarchy among them.

Certainly, much can be said in favour of self-regulation, and the SGO proposed by the Task Force. However, being so broadly based, the proposed SGO would have proved to be more of a forum for discussion and exchange of views rather than a decision making body. At the same time, the proposed POB, may not be anchored well enough in government, is mandated primarily with oversight, and is very much part and parcel of the SGO-based system. Hence, the Task Force's recommendations on regulation and governance are problematic.

On the other hand, as indicated above in Part VIII, the Task Force recommended that a reformed CPA would be transformed into a core infrastructure entity and become a non-share capital corporation with no shareholders, with access to debt financing and power to charge fees based on full cost recovery. Participants would include payment service providers who qualify for access. Decision-making power would be vested solely in its board, to be composed of three federal government appointees, three participant appointees and three independents. In addition, the Bank of Canada would sit on the board in an observer capacity. On this point, as discussed above in Part IX, a new legislation provides for a CPA board consisting of majority of independent directors as well as for enhanced accountability of the CPA.

I am in favour of a CPA being a core infrastructure entity as well with providing it with access to debt financing. I am however dubious as to the concern with independent directors. Particularly I am prepared to speculate that it will be difficult to find knowledgeable directors outside the membership and suspect that the technical committee now established under the new legislation may not be the right solution. As will be explained further below, my view is that strengthening accountability to a regulator or overseer may be a better solution for enduring the public interest. As for CPA membership my own recommendation is to include national network operators and having a two-tiered system with the direct clearer being tier one membership. Tier two should consist of payment service providers who qualify for access.

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[54] B. Crawford, "Final Report of the Task Force for Payments System Review: Modernization to Promote E-Commerce", (2012), 53 CBLJ, 167.

As already stated, I do not disfavour the SGO idea, and yet what I envision is an organization with broad membership acting as a forum for discussions, exchange of views, and hopefully as a catalyst for a consensus. For example, facilitating "the development of new payment methods and technologies", for which the CPA is mandated under CP Act s. 5(1)(c),[55] is in fact a proper task for such an organization. At the same time I disfavour the POB idea as I do not think another layer of government or public interest guardian is needed.

Similarly, I have reservations with the regard to the current government scheme. Inasmuch as the CPA is mandated to "promote the efficiency, safety and soundness of its clearing and settlement systems and take into account the interests of users"[56] I am inclined to suggest that it will be made to be accountable to BOC and not to the Minister of Finance. Indeed, the failure to act as directed by the quoted provision, is potentially a source for a "payment system risk" for which the power to minimize or eliminate is vests in the BOC.[57] The same is true for the payment system safety and efficiency as well as financial system best interest, which at present underlie the Minister's power under CP Act s. 37(2).[58] Instead, the failure to adhere to them creates a "payment system risk" and thus should be handled as part of the BOC's oversight. For its part, BOC's oversight is to be extended to the entire payment system and not only the interbank domain.

The other element mentioned in CP Act s. 37(2) is the competitiveness of the payment system. This is however a matter of market conduct. Both market conduct and prudential regulation of money transmitters and other providers of payment services is to remain vested in the government's responsibility. It is beyond the scope of this paper to address the division of this task among the various Ministries as well as the federal and provincial level in Canada.[59]

In the final analysis Canada has a well-functioning safe and sound payment system for which governance vests in principal service providers. As pointed out by the Task Force, this may not satisfy everybody's needs and may well be at the expense of accessibility, competition and innovation. Hence, and in order to achieve an optimal balance among all competing policies, reform is called for. In its framework, statutes and regulations are to be revised and the distribution of legislative powers is to be assessed and adjusted. In undertaking this reform project, the existence of varying approaches for details is to be recognized. At the same time, looking forward, the core principle of self-regulation subject to an oversight and direction seems to be agreed upon and ought to be preserved in guiding towards any future development.

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[55] See above in Part IV.

[56] CP Act s. 5(2) discussed above in Part IV.

[57] See discussion above in Part III.

[58] Discussed above in Part X.

[59] In general for the latter aspect see B. Geva, "Payment Law: Legislative Competence in Canada", forthcoming, (2015), 31 BFLR ??? .

Addendum: Payment System Regulation and Governance in South Africa: Overview

As BOC in Canada, South African Reserve Bank ("SARB"), which is the central bank in South Africa, provides on its books final settlement to interbank payments. To that end, SARB introduced a sophisticated settlement system called South Africa Multiple Option Settlement (SAMOS). The SAMOS system is a subset of the general ledger of the SARB. Interbank retail payment transactions are cleared and submitted to SAMOS for settlement by BankserAfrica which is owned by South Africa clearing and settlement banks. BankserAfrica, Strate Limited for securities settlement and Visa and MasterCard for international card schemes are the operators of the Payment Clearing House(PCH) system. Unlike in Canada, real time clearing (RTC) is available for customers using internet banking.[60]

Similarly to the BOC in Canada, SARB is authorized to designate settlement systems. This power is given to SARB under the National Payment System Act 78 of 1998 ("NPSA"). Under NPSA s. 4A(1),

> The Reserve Bank may designate a settlement system if such designation is in the interest of the integrity, effectiveness, efficiency or security of the payment system.

Under NPSA s. 4A(3),

> In considering the designation of a settlement system, the Reserve Bank may have regard to any or all of the following matters:
>
> > (a) The purpose and scope of the settlement system;
> > (b) the rules of the settlement system;
> > (c) any laws or regulatory requirements relating to the operation of the settlement system, and the extent to which the settlement system complies with those laws or regulatory requirements;
> > (d) the importance of the settlement system to the national financial and payment system;
> > (e) any other matters that the Reserve Bank considers appropriate.

NPSA s. 4A goes on to provide that terms and conditions under which designation has been made is to be publicized and that non-compliance with such terms and conditions is one reason for the revocation of the designation or the variation of its terms and conditions.

As in Canada, the SARB is given a broad directive issuance power. However, unlike in Canada, the application of this power is not limited to designated clearing and settlement system. Rather, under NPSA s, 12 (1), "after consultation with the payment system management body" (to be discussed further below), SARB may "issue

[60] CPSS, "Payment, clearing and settlement in South Africa" *Red Book* (Basel: BIS, 2012), at Introduction, 1.3.3, 2.2.1.1 and 3.1 to 3.7. The publication is available online: https://www.bis.org/cpmi/publ/d105_za.pdf?

directives to any person regarding a payment system[61] or the application of the provisions of this Act". Under NPSA s. 12(2), grounds for such directive, may be systemic risk; "public interest relative to the integrity, effectiveness, efficiency or security of the payment system;" the public interest; the integrity, effectiveness, efficiency or security of the payment system; national financial stability; any other matters that the Reserve Bank considers appropriate. Over and above such a directive, SARB may target "a person"[62] and issue directives against individuals, requiring them to perform or refrain from performing certain acts (NPSA s. 12(3).
Several provisions in NPSA have no parallel in Canada. Thus, under NPSA s. 5(1),

> Settlement is effected in money or by means of entries passed through the Reserve Bank settlement system or a designated settlement system

Under NPSA s. 5(2), such settlement "is final and irrevocable and may not be reversed or set aside."[63]

Unlike in Canada, money transmission is strictly regulated. Under NPSA s. 7,

> A person may as a regular feature of that person's business accept money or payment instructions from any other person for purposes of making payment on behalf of that other person to a third person to whom that payment is due, if -
>
> > (a) the first mentioned person is the Reserve Bank, a bank, mutual bank, a co-operative bank, a designated clearing system participant, branch of a foreign institution, or a designated settlement system operator; or
> >
> > (b) the first-mentioned person is the postal company defined in section 1 of the Post Office Act, …or the Postbank as defined in section 51 of the Postal Services Act …; or
> >
> > (c) the money is accepted or payment made in accordance with directives issued by the Reserve Bank … .

Fundamental differences between Canada and South Africa exist as to the overall position of the central bank and the legal status of the infrastructure organization. First, unlike in Canada, SARB is entrusted with the leadership of payment system developments. Thus, under s. 10 of South African Reserve Bank Act 90 of 1989,

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[61] Broadly defined to mean in NPSA s. 2, as a system that enables payments to be effected or facilitates the circulation of money and includes any instruments and procedures that relate to the system

[62] Defined in s. 1 to include a trust.

[63] Similarly, under NPSA s. 5(3),

An entry to or payment out of the account of a designated settlement system participant to settle a payment or settlement obligation in a designated settlement system is final and irrevocable and may not be reversed or set aside.

> (1) The Bank may, subject to the provisions of section 13 [dealing with prohibited business]-
>
> …
>
> (c) (i) perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems;
>
> (ii) form, or take up shares or acquire an interest in, any company or other juristic person that provides-
>
> (aa) a service for the purpose of or associated with; or
>
> (bb) any facility for or associated with, the utilization of any such payment, clearing or settlement systems;
>
> (iii) perform the functions assigned to the Bank by or under any law for the regulation of such payment, clearing or settlement systems; and
>
> (iv) participate in any such payment, clearing or settlement systems;

NPSA s. 2 confirms this power. NPSA s. 3 goes on to provide as follows with regard to a payment system management body, its relationship with the SARB, and the restricted access to the SARB's settlement facilities:

> (1) Subject to subsection (2), the Reserve Bank may recognise a payment system management body established with the object of organising, managing and regulating the participation of its members in the payment system.
>
> (2)The Reserve Bank may recognise a payment system management body as contemplated in subsection (1) if the Reserve Bank is satisfied that-
>
> (a) the payment system management body, as constituted, fairly represents the interests of its members;
>
> (b) the deed of establishment or constitution, as the case may be, and the rules of the payment system management body, including the rules relating to admission as members of that body, are fair, equitable and transparent; and
>
> (c) the payment system management body will enable the Reserve Bank to adequately oversee the affairs of the payment system management body and its members and will assist the Reserve Bank in the discharge of the Reserve Bank's responsibilities, specified in section 10(1)(c)(i) of the South African Reserve Bank Act, regarding the monitoring, regulation and supervision of payment, clearing and settlement systems.
>
> ...

(3) Besides the Reserve Bank, the following may also be members of a payment system management body:

(a) A bank, mutual bank, a cooperative bank or branch of a foreign institution; and

(b) a designated clearing system participant that complies with the entrance and other applicable requirements laid down in the rules of the payment system management body.

(4) No person may participate in the Reserve Bank settlement system unless-

(a)such person is the Reserve Bank, a bank, a mutual bank, a co-operative bank or a branch of a foreign institution and, in the case where a payment system management body has been recognised by the Reserve Bank as contemplated in subsection (1), such person is a member of the payment system management body so recognised;

(b) such person is a designated settlement system operator; or

(c)Such person meets the criteria for participation in the Reserve Bank settlement system as established by the Reserve Bank in consultation with the payment system management body.

(5) No person may be allowed to clear as contemplated in section 4(2)(d)(i) unless, in the case where a payment system management body has been recognised by the Reserve Bank as contemplated in subsection (1), such person is a member of the payment system management body so recognised.

The objects and other qualifications for the payment system management body are set out in NPSA s. 4 as follows:

(1)The objects of the payment system management body are to organise, manage and regulate, in relation to its members, all matters affecting payment instructions and, in connection with those objects-

(a) to provide a forum for the consideration of matters of policy and mutual interest concerning its members;

(b) to act as a medium for communication by its members with the South African Government, the Reserve Bank, the Registrar of Banks, the Co-
operative Bank Supervisor, the Registrar of Financial Institutions, any financial or other exchange, other public bodies, authorities and officials, the news media, the general public and other private associations and institutions; and

(c)to deal with and promote any other matter of interest to its members and to foster co-operation between them.

(2)In addition to any other provisions thereof, the rules of the payment system management body must empower that body

-

(a)to admit members and to regulate, control and, with the approval of the Reserve Bank, terminate membership;

(b) to constitute, establish or dissolve any body, committee or forum consisting of its members and which has an impact on, interacts with, has access to or makes use of payment, clearing or settlement systems or operations;

(c) to

-

(i) recommend for approval by the Reserve Bank, criteria subject to which any person is granted membership of the payment system management body or is to be authorised to act as a system operator or a PCH system operator within a payment system; and

(ii) authorise that person to act as a system operator or PCH system operator in accordance with those criteria; and

(d) to recommend for approval by the Reserve Bank criteria subject to and in accordance with which a member that is also a Reserve Bank settlement system participant may be authorised to-

(i)allow a bank, a mutual bank, a co-operative bank, a designated clearing system participant or branch of a foreign institution that is not a Reserve Bank settlement system participant to clear; or

(ii) clear on behalf of a bank, a mutual bank, a co-operative bank, a designated clearing system participant or a branch of a foreign institution that is not a Reserve Bank settlement system participant:

Provided that the member shall settle payment obligations on behalf of such bank, mutual bank, co-operative bank, designated clearing system participant or branch of a foreign institution referred to in subparagraphs (i) and (ii)

Pursuance to this, SARB recognized the Payment Association of South Africa (PASA) to be the payment system management body established with the object of organizing, managing and regulating the participation of its members in the payment system. PASA thus manages the conduct of its members in all matters relating to payment system instructions and supports the SARB in its role as an overseer of the payment system. PASA ensures members' compliance, and to that end, where necessary, imposes on them penalties and sanctions.[64]

[64] *Red book*, above note 60 at 1.3.2.

Reflections and financial regulatory reforms post financial crisis –how far have we come?

Angela Itzikowitz

Introduction

The 2008 financial crisis has demanded reflection on the role and scope of the financial sector, the balance between regulation and freedom, the moral hazard dilemma and the devastating effects that systematic failure can cause in the financial sector.[1] There are always a number of lessons to be learnt from a financial crisis; in in respect of the 2008 crisis, these include the need to adopt an holistic view of the financial sector and financial sector regulation; the need to re-think moral hazard; and the need to appreciate just how inter-connected the global channels of funding are, such that risks arising in one part of the global financial system are transmitted across borders with disastrous consequences.

South Africa, through its participation in G20 forums, including the Financial Stability Board ("FSB"), has committed to implementing a number of financial reforms, some of which were considered or conceived of prior to the 2008 crisis. These reforms include a commitment to implementing Basel III regulations and the Solvency and Asset Management measures ("SAM", in the insurance industry); to developing a framework to supervise Systematically Important Financial Institutions ("SIFIs"); to regulating Over-The-Counter ("OTC") derivatives and credit rating agencies; to revisiting issues relating to moral hazard; and to considering the extent and regulation of the shadow banking system.

In this paper, I shall focus briefly on some of these reforms, as well as aspects of the Twin Peaks regulatory architecture.

Financial Market Regulation[2]

The regulation of financial institutions is aimed at efficiency, flexibility, fairness, safety and soundness, equitable distribution of economic power and the implementation of monetary policy. Efficiency relates to the effectiveness of market participants; flexibility to the ability of the regulatory system to adapt to changes in the industry; fairness to the interests of both the public and the regulated industry;[3] safety and soundness relates to the attributes of the financial system; the equitable distribution of power to a value judgement on monopolies and related matters; and the

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[1] See generally the keynote address delivered by erstwhile Minister of Finance, Pravin Gordhan at the Banking Association's 2011 Banking Summit, 23 August 2011, available at http://www.gov.za/banking-associations-2011-banking-summit-keynote-address-minister-finance-pravin-gordhan (hereafter "Keynote Address").

[2] See generally Arner and Jan-juy Lin (ed), *Financial Regulation A Guide to Structural Reform* (2003, Sweet & Maxwell) and, specifically, Itzikowitz, "Financial Market Regulation in South Africa" at 433.

[3] Friedman and Friesen, "A New Paradigm for Financial Regulation: Getting from here to there" (1984) *Maryland Law Review* at 413,445-462.

implementation of monetary policy concerns what may be imposed by law on the regulatory authorities.[4] Although views on financial regulation differ, undoubtedly at least two of its important purposes are to maintain stability in financial markets and to guarantee that the vicissitudes in economic activity do not undermine the economic health of nations and of the world economy.[5]

South Africa currently has a segmented regulatory structure, where banks are regulated and supervised by the Registrar of Banks as part of the South African Reserve Bank ("SARB") while most other financial institutions are supervised by the Financial Services Board, a statutory body created in terms of the Financial Services Board Act 1990.

The regulation of financial institutions in South Africa is, however, in the process of being comprehensively overhauled and a new regulatory regime, the 'Twin Peaks' Model, implemented. The proposed Twin Peaks Model is designed to make the financial sector safer and to provide better protection to financial consumers. The model gives effect to the policy paper published in February 2011 entitled "*a Safer Financial Sector to serve South Africa better*" which, taking into account the lessons learnt from the 2008 crisis and the structure and characteristics of South Africa's financial sector, sets out proposals to reform the regulatory architecture of the South African financial sector.[6]

The South African financial system has a number of features that suggest that a Twin Peaks approach to regulation is the correct one. Among other things, the financial sector is highly interconnected and dominated by financial groups (or 'financial conglomerates'), each of which typically comprises a bank and an insurance company.[7] The rise of financial conglomerates has led regulators to seek to identify ways to efficiently and effectively oversee their operations; fragmented supervision raises concerns as to the ability of sector supervisors to form an overall risk assessment of the institution on a consolidated basis and to adequately address group-wide risks.[8] Financial sector supervisors should also be able to respond on an institution-wide basis should serious problems occur in any part of the conglomerate.[9] Moreover, international experience has shown that while the individual entities which comprise a conglomerate generally claim to have financial 'firewalls' between their various operations, when serious difficulties arise these walls often prove to be largely illusory.[10] Although it may be possible for a number of

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[4] Friedman and Friesen, *ibid.* Cf Breyer, "Analysing Regulatory Failure: Mismatches, Less Restrictive Alternatives and Reform" (1989) *Harvard Law Review* at 549, 551H.

[5] Edwards, "Financial Institutions and Regulation in the 21st Century: After the Crash", in Verheirstraeten (ed), *Competition and Regulation in Financial Markets* (1982, Macmillan).

[6] See generally http://www.treasury.gov.za/twinpeaks

[7] See Twin Peaks in South Africa: Response and Explanatory Document Accompanying the Second Draft of the Financial Sector Regulator Bill, December 2014 at http://www.treasury.gov.za/public%20comments/FSR2014/2014%2012%2012%20Response%20document.pdf

[8] Abrams and Taylor (above n 2) at 44.

[9] See Itzikowitz (above n 2).

[10] Abrams and Taylor (above n 2) at 44.

specialist regulators to co-operate in the supervision of a diversified financial conglomerate by using the 'lead-regulator' arrangement, a unified model would seem to offer a better approach to the co-ordination and exchange of information than would occur between separate agencies.[11] Furthermore, the fragmented regulatory landscape has resulted in a 'silo' approach to financial regulation with the relevant sectoral statutes and sectoral regulators often at odds with one another.

Giving content and form to the proposed Twin Peaks model, the first draft of the Financial Sector Regulation ("FSR") Bill was published in December 2013 and the second (on which this paper is based) in December 2014. It should be pointed out that a new (a third) draft FSR Bill is scheduled to be tabled in Parliament in June 2015 and I am aware that there have been a number of changes to this draft. For this reason I have largely steered away from discussing in great detail the provisions of the FSR Bill and speak rather to the general architecture of the Twin Peaks model.

The FSR Bill is only part of the Twin Peaks reform process. Other steps which form part of the reform process include the development of a framework for market conduct[12] and new prudential requirements.

The Twin Peaks reform process will be undertaken over a number of years and will be introduced through a phased approach. In the first phase, two new authorities will be created: namely, the Prudential Authority ("PA"), who will be charged with prudential regulation, and the Financial Sector Conduct Authority ("FSCA"), the market conduct authority which will oversee market conduct. The FSCA will be a stand-alone authority while the PA will be an authority established within the SARB. The objectives of the two authorities are quite distinct and strong co-operation and co-ordination between them will be required. The SARB will oversee financial stability within a policy framework agreed with the Minister of Finance and will be responsible for macro-prudential regulation. The PA will focus on micro-prudential supervision.

In the first phase, existing sectoral legislation will remain largely unchanged and existing licenses will be retained but the responsibility for the existing statutes will change to either the PA or the FSCA. The FSR Bill makes provision for limited additional licensing powers for the PA and FSCA in respect of newly-designated products and services and it requires cooperation between authorities for new licenses and withdrawal of or changes to existing legislation.

The second phase will involve developing the legal frameworks for prudential and market conduct regulation. It will involve the repeal of the sectoral specific laws and their replacement with new overarching legislation and new licensing procedures in terms of which institutions will be

[11] See Abrams and Taylor (above n 2) at 44.

[12] The document entitled "Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework For South Africa", which proposes a streamlined market conduct framework, was published with the second FSR Bill and is available at http://www.treasury.gov.za/public%20comments/FSR2014/Treating%20Customers%20Fairly%20in%20the%20Financial%20Sector%20Draft%20MCP%20Framework%20Amended%20Jan2015%20WithAp6.pdf.

required to obtain a license from the PA and a separate license from the FSCA. Until Phase II is fully developed the current industry-based 'silo' approach to regulation will obtain, though provision is made for consultation and co-operation between the regulators.

Financial conglomerates

International standard setters require that regulation and supervision apply to financial conglomerates and not only to the individual entities within a financial group. The FSR Bill gives effect to this by providing for a framework for the supervision of financial conglomerates, an important area which is not currently well addressed in our current financial sector legislation.

A financial conglomerate is defined in section 1 of the FSR Bill as a group of companies that comprise one or more "eligible financial institutions" as well as its holding companies (including any controlling companies), related persons or inter-related persons (including persons located or incorporated outside of South Africa), and associates[13] but excludes any holding company or similar entity that is incorporated outside of South Africa. An "eligible financial institution" is in turn defined to mean any of the following: a financial institution licensed or required to be licensed as a bank in terms of the Banks Act; a financial institution licensed or required to be licensed as a long-term insurer in terms of the Long-term Insurance Act or a short-term insurer in terms of the Short-term Insurance Act; a market infrastructure; or a financial institution as prescribed in regulations. "Financial institution" is defined to mean a financial product provider; a financial service provider; a market infrastructure; a payment system operator, excluding the Reserve Bank; a settlement system; or a controlling company of a financial conglomerate. A "systemically important financial institution" is defined as a financial institution or a financial conglomerate designated as such in terms of section 73 of the FSR Bill.

A holding company of a financial conglomerate must incorporate or convert to become a controlling company of the financial conglomerate within 6 (six) months of being informed of the scope of the financial conglomerate by the Prudential Authority.[14] The board of a controlling company must inform the Prudential Authority of any change in the structure or risk profile of the financial conglomerate that may impact on the scope of the financial conglomerate and the board is responsible for meeting the requirements imposed on the financial conglomerate.[15]

The Prudential Authority is empowered to direct a controlling company to amend the structure of the financial conglomerate if the structure impedes the safety and soundness of any eligible financial institution or the ability of the prudential authority to determine how the different types of businesses are conducted, the risks of the financial conglomerate and each constituent of the financial conglomerate and the manner in which the governance framework is organised and

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[13] This is as identified in the International Financial Reporting Standards ("**IFRS**").

[14] See section 12 of the FSR Bill.

[15] See section 124 of the FSR Bill.

conducted for the conglomerate and each constituent of the conglomerate.[16] The Prudential Authority is furthermore empowered to set prudential standards with respect to the safety and soundness of financial institutions for purposes of ensuring that financial product providers will be able to comply with their obligations to financial customers in relation to financial products; ensuring that payment system operators, market infrastructures, participants in the payment system and members of market infrastructures, will be able to comply with their obligations to each other and financial customers, as applicable; and assisting in maintaining financial stability. In terms of section 94(3), a prudential standard may apply to financial institutions, key persons, financial products, market infrastructures or payment systems generally; or particular categories or sub-categories of financial institutions, key persons, financial products, market infrastructures or payment systems. In terms of section 128, the power of the Prudential Authority to make prudential standards extends to making standards in relation to financial conglomerates, controlling companies and the entities that are part of the financial conglomerates.

The FSCA is empowered in terms of section 95 to make conduct standards, including standards in relation to financial conglomerates and the entities that are part of the financial conglomerates.

The separation of prudential and market conduct regulation is to be welcomed as each involves different approaches and culture. However, a moral hazard concern may arise unless information is properly disseminated to customers - this concern is based on the premise that consumers will tend to assume that all creditors of institutions supervised by a given supervisor will receive equal protection.[17] For example, if depositors are protected from a loss in the event of bank failure, then the customers of other financial institutions supervised by the same regulatory authority may expect to be treated in the same manner.[18]

In a rapidly changing market environment, traditional views on financial regulation should continue to be subject to scrutiny and challenge - it should never be taken as axiomatic that regulation is always effective and efficient and sufficiently tailored to achieving its objectives.[19] If the ultimate purpose of regulation is to protect the consumer and to serve systemic interests, then it must be tested so as to be sure that it does so effectively and cost efficiently.[20] However, changing the structure of regulation cannot of itself guarantee effective supervision.[21]

It must also be remembered that any process of change or reform will involve risk. The greater the proposed structural changes, the greater the risks will be. Furthermore, the process of

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[16] Section 126.

[17] Abrams and Taylor (above n 2) at 51.

[18] Abrams and Taylor, *ibid*.

[19] Itzikowitz (above n 2) at 449.

[20] Itzikowitz (above n 2) at 449.

[21] Abrams and Taylor (above n 2) at 41.

change must be properly managed and must not become politicised.[22] Most importantly, the development of regulatory capacity and expertise must be given prominence over the issue of regulatory structure.[23]

Regulation of OTCs

The Financial Markets Act 19 of 2012 ("FMA") came into force on 3 June 2013, replacing the Security Services Act 36 of 2004, and aims to achieve financial markets that are fair, efficient and transparent. To achieve this objective, the FMA applies standards consistent with the IOSCO Objectives and Principles of Securities Regulation. These include principles relating to a strong, independent and accountable regulator; principles of good governance and models of industry self-regulation; and principles relating to specific categories of regulated persons (including issuers and market intermediaries).

In line with the recommendations of the G20, the FMA makes provision for the regulation of OTC derivatives: "securities" is defined in section 1 of the FMA to include listed and unlisted derivative instruments while "derivative instrument" is defined to mean any financial instrument or contract *"that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event*". The significance of the definition of "securities" (read with the definition of "derivative instrument") is that OTCs *qua* unlisted "securities" are now clearly regulated in terms of the FMA.

The extent to which the FMA regulates OTCs has, however, been a source of much confusion given the prohibition in section 4(1)(c) of the FMA on persons providing securities services *"in respect of unlisted securities in contravention of conditions imposed or prescribed under section 6(7)*". Section 6(7) provides that:

> "*(7) The registrar may, in accordance with the requirements prescribed by the Minister under section 5(1)(a),-*
> *(a) prescribe criteria for the authorisation of persons providing securities services in respect of unlisted securities;*
> *(b) prescribe conditions and requirements for the provision of securities services in respect of unlisted securities, including, but not limited to, prescribing a code of conduct and imposing reporting requirements;*
> *(c) prescribe standards in accordance with which securities services in respect of unlisted securities must be carried on;*
> *(d) prescribe conditions and requirements in terms of which securities services in respect of specified types of unlisted securities may be provided, including, but not limited to, the manner in which clearing and settlement of such securities must take place;*
> *(e) prescribe criteria for the authorisation of issuers of unlisted securities; and*
> *(f) prohibit a person from providing any securities services in respect of unlisted securities if that person provides securities services in a manner which defeats one or more of the objects of this Act referred to in section 2.*"

[22] Abrams and Taylor *ibid*.

[23] Abrams and Taylor *ibid*.

The prohibition in section 4(1)(c) refers to conditions imposed in terms of section 6(7), which conditions are in turn subject to (or must at least be in accordance with) the requirements prescribed by the Minister under section 5(1)(a). Given that the Minister has not yet prescribed such requirements, the Registrar of Securities Services ("Registrar"), in turn, cannot prescribe conditions in terms of section 6(7). As such, the prohibition in section 4(1)(c) is currently meaningless.

The draft regulations promulgated in terms of the FMA published on 4 July 2014 ("Draft FMA Regulations") further extend the scope of application of regulation to unlisted securities, in particular the OTC derivatives market, by seeking to create the conditions that would give meaning to section 4(1)(c) of the Act. The Draft FMA Regulations define "OTC derivative" to mean "*an <u>unlisted</u> derivative instrument, categorised in regulation 2, excluding –*

> *(a) insurance contracts, as provided for in the Long-term Insurance Act, 1998 (Act No. 52 of 1998) or the Short-term Insurance Act, 1998 (Act No. 53 of 1998);*
>
> *(b) foreign exchange spot contracts; and*
>
> *(c) physically settled or physically deliverable commodity contracts."*

The Draft FMA Regulations categorises derivatives along asset classes (i.e. interest rates, foreign exchange, credit, equities and commodities) and defines an "OTC derivative provider" ("ODP") to mean a person who, as a regular feature of its business, and transacting as principal –

> *"(a) originates OTC derivatives; or*
>
> *(b) makes a market in OTC derivatives*;"

In terms of these Draft FMA Regulations,[24] a ODP will be obliged to be licensed by the Registrar under the FMA; comply with certain prescribed obligations; report OTC derivative transactions to the licensed trade repository (or a recognised trade repository in the form and manner prescribed by the registrar under section 58 of the FMA); and ensure that OTC derivative transactions are cleared though a central counterparty in the form and manner prescribed by the Registrar.[25] The FMA Regulations also prescribe the functions and duties that may be undertaken by non-South African clearing houses, central counter-parties and trade repositories.

The FMA provides that, subject to regulations prescribed by the Minister, the Registrar may prescribe reporting obligations in respect of transactions or positions in unlisted securities which must be reported to a trade repository. The FMA defines "trade repository" to mean "*a person who maintains a centralised electronic database of records of transaction data*". Section 54 of the FMA provides that a trade depository must be licensed under section 56, and must comply with the licensing requirements listed in section 55. Some of the requirements include having electronic systems to calculate open positions by class of derivatives to ensure effective monitoring of

[24] Available at http://www.treasury.gov.za/public%20comments/OTC/.

[25] Section 5(1)(b) of the FMA.

systematic risk and the supervision of the OTC derivatives market and an ability to interact safely and securely with other market infrastructures and service providers. ODPs will be required to report all OTC transactions to the licensed trade repository and trade repositories must provide the Registrar with any information requested to monitor and mitigate systemic risk. The trade repository will add an element of transparency to OTC trading, which could in turn enhance the oversight function of the regulatory authorities over the OTC market.

Credit Rating Agencies

Fair and reasonable credit ratings are important to the integrity of the financial system, assisting financial institutions to understand the credit risk associated with the range of financial products that they invest or trade in. The Credit Rating Services Act seeks to give effect to the G20 and IOSCO recommendations that credit rating agencies should be subject to regulatory oversight, including registration and ongoing supervision.

Given the role that credit rating agencies play in a financial institution's monitoring and mitigation of credit risk, strong regulatory oversight is necessary to ensure that all persons performing credit rating services are registered and adhere to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies ("Code"). The Code is based on the principles of quality and integrity of the rating process; the independence of the credit rating agency and the avoidance of conflicts of interest; and the responsibilities to the investing public and issuers. This obliges credit rating agencies to adhere to strict standards when issuing credit ratings, and strong enforcement action will be taken against breaches, including suspension or deregistration. In particular, these organisations should be required to introduce governance arrangements that support fair, unbiased and accurate ratings, which as far as possible reasonably estimate the risk associated with the entity or activity being rated.

To this end, the South African legislature adopted the Credit Rating Services Act 24 of 2012 in 2013. This Act seeks to give effect to the G20 recommendations on the regulation and registration of credit rating agencies and to the IOSCO Principles set out above. The Credit Rating Services Act requires any person or entity who performs data and information analysis, approval, issuance and review of credit ratings in South Africa, publishes a credit rating in South Africa, or issues credit ratings that are published in South Africa, to register as a credit rating agency.

Conclusion

These debates, and those around moral hazard, "too big to fail" and deposit insurance, are likely to endure. Financial systems globally are in the process of major overhaul and the tendency internationally has been to harmonise national financial regulation with international standards – and to this extent South Africa's post-crisis reform is on point. Furthermore, traditional views on financial regulation should rightly be subject to scrutiny and challenge and to this extent the Twin Peak reform process illustrates that South Africa's regulatory environment is anything but static.

<u>**The impact of the twin peaks model on the insurance industry**</u>

D Millard[*]

INTRODUCTION

The delicate balance between over-regulating and under-regulating is a matter that will not be settled in our time. To complicate matters, government has started to move away from the so-called practice of "silo" regulation and supervision, that focuses on supervision according to industry (such as banking and insurance), to a model which regulates according to function, for example systemic risk management and consumer treatment (the so-called "Twin Peaks" model).[1]

The Financial Sector Regulation Bill (FSR Bill) is the first step towards the implementation of the Twin Peaks model. After publication of the first draft bill, a period was allowed for comment from 13 December 2013 to 7 March 2014. Several comments were received on various aspects of the draft bill, and on matters pertaining to insurance and intermediaries. The Association for Savings and Investment South Africa (ASISA), the Financial Intermediaries Association of Southern Africa (FIA) and the South African Insurance Association (SAIA) made submissions on a number of issues, such as the definition of "financial crisis" in the draft bill. The revised version still does not contain a definition of "financial crisis" but now defines "systemic event" and "systemic risk" and chapter 2 of the Bill explains the Reserve Bank's powers and responsibilities in managing systemic risk and systemic events.[2]

The second draft of the FSR Bill took a number of other comments into account. For instance, the Bill no longer refers to "*mono and dual*" regulation by authorities. Rather, it provides that financial product providers will be regulated and supervised by the Prudential Authority and financial service providers will resort under the Financial Sector Conduct Authority. Furthermore, clause 2 of the Bill defines a financial product as follows:

> "(a) a participatory interest in a collective investment scheme;
> (b) an interest, subscription, contribution, or commitment in a pooled fund;
> (c) a long-term or a short-term policy, as defined in section 1(1) of the Long-term Insurance Act and section 1(1) of the Short-term Insurance Act, respectively;
> (d) a benefit provided by—

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[1] Gilmour "South Africa 2014's Twin Peaks – No, It's Not Next Year's Play Boy Calendar…" *Moneyweb* 5 May 2015, www.moneyweb.co.za/archive/2014s-twin-peaks/ (05-05-2015).

[2] National Treasury Financial Sector Regulation Bill – Comments Received On The First Draft Bill Published by National Treasury for Comments in December 2013 (Comment Period from 13 December 2013 – 07 March 2014) 3, 7.

(i) a pension fund organisation as defined in section 1(1) of the Pension Funds Act, to the members of the organisation by virtue of membership; or

(ii) a friendly society as defined in section 1(1) of the Friendly Societies Act, to the members of the society by virtue of membership;

(e) a deposit as defined in section 1(1) of the Banks Act;

(f) a health service benefit provided by a medical scheme as defined in section 1(1) of the Medical Schemes Act, 1998 (Act No. 131 of 1998);

(g) a credit agreement;

(h) a facility, arrangement or system that is designated by the Minister in terms of subsection (2) in Regulations as being a "financial product";

(i) any combined product containing one or more of the financial products referred to in paragraphs (a) to (h)."

This definition corresponds with the current definition of "financial product" in the FAIS Act.[3] The Prudential Authority will henceforth be responsible for supervising safety and soundness of financial institutions that provide financial products, market infrastructures or payment systems.[4] Prudential oversight is aimed to ensure that institutions meet financial obligations to customers.[5]

The other peak, the Financial Sector Conduct Authority, is expected to be responsible for fair treatment, integrity and education, and will supervise services performed in relation to financial products, foreign financial product, securities, market infrastructure or the payment system.[6] What is important to note is that the definition of "financial service" is quote comprehensive and differs markedly from the current definition of "financial service" in the FAIS Act.[7] "Financial service" in the FSR Bill means—

"(a) in relation to a financial product, foreign financial product, securities, market infrastructure or the payment system as applicable—

(i) promotion, marketing or distribution;

(ii) providing advice, recommendations or guidance;

(iii) dealing or making a market;

(iv) operating or managing, or providing administration services;

(v) services provided in relation to credit agreements, including legal services;

(vi) services provided by payment system participants;

(b) providing an intermediary service as defined in section 1(1) of the Financial Advisory and Intermediary Services Act;

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[3] S 1(1), *sv* "financial product".

[4] Clauses 27 – 29 of the FSR Bill.

[5] The FSR Bill also allows the Minister in terms of section 215 and in accordance with section 231(3) to designate in Regulations as a "financial product", a category or type of facility, arrangement, or system that is not already regulated in terms of a financial sector law; and cannot be designated in Regulations in terms of another financial sector law to be regulated in terms of that financial sector law. This designation is aimed at furthering the objectives of the FSR Bill.

[6] Clause 3 of the FSR Bill.

[7] The current definition in section 1(1) of the FAIS Act stipulates that a financial service "means any service contemplated in paragraph *(a), (b)* or *(c)* of the definition of 'financial services provider', including any category of such services."

(c) securities services provided by a regulated person as defined in section 1(1) of the Financial Markets Act;

(d) providing credit rating services as defined in section 1(1) of the Credit Rating Services Act, 2012 (Act No. 24 of 2012);

(e) the calculation of a financial benchmark;

(f) services related to an interest, subscription, contribution, or commitment in a pooled fund;

(g) services related to the buying and selling of foreign exchange;

(h) dealing with trust property, as defined in section 1 of the Financial Institutions (Protection of Funds) Act, 2001 (Act No. 23 of 2001), as a regular feature of business;

(i) a service that is designated by the Minister in terms of subsection (2) in Regulations as a financial service."

The purpose of this paper is to discuss the implications of the FSR Bill for the insurance industry. Instead of analysing the Bill feature for feature, the method that will be used in this enquiry is to identify trends and issues from 2014 and to discuss whether the Twin Peaks model, once implemented, can successfully eradicate similar problems in future. The impact of Twin Peaks will of course have to be tested, but at this point in time it may be very useful to take an educated guess by using recent cases as examples. Recent cases before the courts, the Enforcement Committee and the FAIS Ombud will be discussed not only as examples of the most prevalent issues of the past year or so, but also as examples of how consumer issues and systemic risks are currently being dealt with and how this may change with the implementation of the FSR Bill.

PART I: CURRENT REGULATORY FRAMEWORK

The South African insurance industry is highly regulated, which means that, apart from the common law, statutes, together with regulations and rules in terms of these statutes, are a very important source of insurance law. That means that in interpreting insurance contracts, the starting point is always the applicable statute. But insurance legislation also regulates the way in which insurance companies should operate and at the moment, significant parts of the existing statutes are dedicated to these matters. In short, the Long-term Insurance Act (LTIA)[8] and the Short-term Insurance Act (STIA)[9] regulate product-specific matters and the Financial Advisory and Intermediary Services Act (FAIS Act)[10] regulate the activities of advisors and intermediaries who sell insurance.

[8] 52 of 1998.

[9] 53 of 1998.

[10] 37 of 2002.

1. Twin Peaks: Market Conduct and the Financial Sector Conduct Authority

Market conduct refers to the way in which financial services providers conduct their business, design and price their products and treat their customers. This function is therefore primarily concerned with the relationship between insurance companies and policyholders and it is in this context that matters pertaining to advertising, compliance with product features and standards, claims handling and dispute resolution becomes relevant.

The discussion that follows provides an overview of the court cases and Ombud decisions of 2014 and views these against the Treating Customers Fairly Outcomes ("TCF"). The discussion will start with the Ombud decisions and will then more on to the court cases. But first, some background on TCF.

2. TCF

A search of the FSR Bill reveals that there is no specific clause that states that there will be such a thing as TCF. Rather, the so-called TCF principles are embedded in the proposed legislation and it is evident that the conduct of financial institutions will henceforth be measured against TCF principles. A perusal of a number of clauses of the FSR Bill makes this evident. For instance, clause 6 of the Bill postulates that it is the object of the proposed act

> "to achieve a financial system that works in the interests of financial customers, and supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the other financial sector laws, a regulatory and supervisory framework that promotes–
> (a) financial stability;
> (b) the safety and soundness of financial institutions;
> **(c) the fair treatment and protection of financial customers;**
> (d) the efficiency and integrity of the financial system;
> (e) the prevention of financial crime;
> (f) financial inclusion; and
> (g) confidence in the financial system." (Own emphasis.)

In addition, clause 52(a) states that the objective of the new Financial Sector Conduct Authority (FSCA) will be to ensure that financial institutions treat customers fairly[11] and the functions of the FSCA are set out in accordance with these objectives.[12]

It is in fact clause 95(1)(c)(i) that authorises the FSCA to make conduct standards to ensure the protection and fair treatment of financial customers. Furthermore, sub-clause 2(a) specifies that in order to achieve this purpose and the other objectives (such as financial literacy), conduct standards will also set out fit and proper requirements and rules relating to

[11] Other objectives include enhancing the efficiency and integrity of the financial system (clause 52 (b)) and providing financial customers and potential financial customers with financial education programs, promoting financial literacy and financial capability (clause 52(c)).

[12] Clause 52.

the composition, roles and responsibilities of governing bodies of financial institutions[13] and the standards of business conduct for financial institution representatives or mandataries.[14] The embedded value of fairness is further evident from clause 95(1)(f) that specifies that there will be standards for the "promotion, marketing, distribution of or access to financial products, financial services, market infrastructures or payment systems". Furthermore, clause 95(g) envisages standards for disclosures in relation to financial products and services and 95(h) for giving advice, recommendations or guidance to financial customers in relation to financial products, financial services or in relation to financial planning.

The remainder of clause 95 makes it clear that there will be standards for ensuring that financial products or financial services suitable to the needs and circumstances of financial customers,[15] that there are standards for financial products or financial services[16] and that there are standards for contracts.[17]

While the current legal status of TCF is debatable,[18] it is a fact that TCF is the new direction that will be followed in the financial services industry and that the new principles-based approach is one of the cornerstones of Twin Peaks. According to National Treasury, "the TCF framework is transforming the way in which the supervision of market conduct happens. Being implemented by the FSB, TCF is an activities-based, cross-cutting and outcomes-driven approach to regulation and supervision, designed to ensure that regulated financial institutions apply specific standards of fairness to all financial customers."[19] What is clear is that financial institutions must demonstrate that they deliver specified outcomes to their customers. These outcomes are the following, namely:

- Customers can be confident they are dealing with firms where TCF is central to the corporate culture;
- Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly;
- Customers are provided with clear information and are kept appropriately informed before, during and after point of sale;
- Where advice is given, it is suitable and takes account of customer circumstances;

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[13] Clause 95(b)(ii) and (iii).

[14] Clause 95(e).

[15] Clause 95(i).

[16] Clause 95(j).

[17] Clause 95(m).

[18] See Millard "Through the looking glass: Fairness in Insurance contracts – A caucus race?" 2014 *Journal of Contemporary Roman-Dutch Law* 547-566.

[19] National Treasury "Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy for South Africa" *Discussion Document* (December 2014) www.treasury.gov.za (04-05-2015) 50.

- Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect; and
- Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.[20]

A closer look at these outcomes reveals that there are existing standards that aim to ensure fair outcomes. Outcome three that deals with clear information before, during and after point of sale and outcome four that deals with the suitability of advice are excellent examples. Section 8 of the General Code of Conduct for Authorised Financial Services Providers and Representatives (GCC) places an obligation on a provider other than a direct marketer to take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives so that the provider can provide the client with appropriate advice.[21] A provider must conduct an analysis for purposes of the advice and identify the product that is the most appropriate to the client's financial needs.[22] What is more, section 8(2) of the GCC states that a provider must take reasonable steps to ensure that the client understands the advice and that the client is in a position to make an informed decision. Therefore, it is reasonably safe to say that many of the principles that are embodied by the TCF outcomes are already part of South African law. It is against this background that some the past year's Ombud determinations, Enforcement Committee cases and high court cases will be discussed.

PART II: OMBUD DETERMINATIONS

1. Mandate of the FAIS Ombud

The FAIS Ombud is a statutory ombud that is constituted by virtue of section 20 of the FAIS Act.[23] The FAIS Ombud derives its authority to adjudicate from the FAIS Act and more specifically from the Rules on Proceedings of the Office of the Ombud for Financial Services Providers, 2003 promulgated by virtue of section 26 of the FAIS Act. Because the FAIS Act

[20] National Treasury "Treating Customers Fairly" 51.

[21] Section 8(1)(a) of the GCC.

[22] Section 8(1)(b) and (c) of the GCC.

[23] This particular section provides as follows: "(1) There is an office to be known as the Office of the Ombud for Financial Services Providers. (2) The functions of the Office are performed by the Ombud for Financial Services Providers. (3) The objective of the Ombud is to consider and dispose of complaints in a procedurally fair, informal, economical and expeditious manner and by reference to what is equitable in all the circumstances, with due regard to – *(a)* the contractual arrangement or other legal relationship between the complainant and any other party to the complaint; and *(b)* the provisions of this Act. (4) When dealing with complaints in terms of sections 27 and 28 the Ombud is independent and must be impartial."

deals with the activities of advisors and intermediaries in respect of all financial products as defined, it is not only insurance intermediaries, advisors and representatives who may fall under the FAIS Ombud's jurisdiction but also those who render any other service in relation to a financial product as defined by the FAIS Act. In addition, a client must first exhaust the internal complaint resolution system and procedures as set out by Part XI of the GCC.[24] As it is, fairness is already a consideration in internal complaint resolution procedures and where disputes cannot be settled and are referred to the FAIS Ombud, the Ombud's mandate is to settle disputes In terms of section 27(5) of the FAIS Act, the Ombud:

> "(a) may, in investigating or determining an officially received complaint, follow and implement any procedure (including mediation) which the Ombud deems appropriate, and may allow any party the right of legal representation;
> (b) must, in the first instance, explore any reasonable prospect of resolving a complaint by a conciliated settlement acceptable to all parties;
> (c) may, in order to resolve a complaint speedily by conciliation, make a recommendation to the parties, requiring them to confirm whether or not they accept the recommendation and, where the recommendation is not accepted by a party, requiring that party to give reasons for not accepting it: Provided that where the parties accept the recommendation, such recommendation has the effect of a final determination by the Ombud, contemplated in section 28(1);
> (d) may, in a manner that the Ombud deems appropriate, delineate the functions of investigation and determination between various functionaries of the Office; and
> (e) may, on terms specified by the Ombud, mandate any person or tribunal to perform any of the functions referred to in paragraph (d)."

If either party rejects a recommendation, the Ombud provides the parties with a final determination but the Ombud may also issue a determination without a recommendation.[25] In making the determination, the Ombud has extensive powers and a determination may include the dismissal of the complaint or the upholding of the complaint. Where a complaint is upheld, this can be done either wholly or partially, which means that the Ombud may award an amount as *fair* compensation for any "financial prejudice" or "damage" suffered. The Ombud may also order the authorised financial services provider, representative or other party involved to what the Ombud may consider as appropriate.[26] Finally, the Ombud may make any other order which a Court may make[27] and a final determination may also include a cost order.[28]

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[24] Section 17(d) of Part XI, titled "Basic principles of systems and procedures" stipulates that internal dispute resolution procedures should be based on fairness in ensuring that a resolution process should be fair to both clients, the provider and its staff.

[25] Moolman *et al Financial Advisory and Intermediary Services Guide* (2010) 223 – 224.

[26] *Ibid.*.

[27] *Ibid*.

[28] *Ibid.*

2. Fairness

Rulings by the FAIS Ombud and any division of the High Court constitute precedents. Where the FAIS Ombud is required to make a determination where the main issue concerns a matter of law, the doctrine of precedent is suitable. However, the doctrine is less well suited to cases where the FAIS Ombud has to issue a determination that is fair to both the respondent (insurer) and the complainant (the insured), since the concept of "fairness" depends on the particular circumstances of the dispute at hand. What is fair between A and B is not necessarily fair between A and C. and in this respect it is submitted that the FAIS Ombud's scheme is seriously flawed. It is predicted that this will only become worse with the implementation of TCF as considerations will be based more on fairness and less on the law.

If one considers the origins of TCF and the way in which these principles are enforced in the UK, it is evident that although there is a lot of scope for infusing the TCF principles in insurance law, these decisions should not be used as precedents. General reporting of the Financial Ombudsman Service FOS on their determinations have been one of the subjects under investigation by Lord Hunt.[29] The arguments against detailed reporting are that the volumes of cases would be too large to manage,[30] that there is a danger of seeing these decisions as precedent-setting[31] and that publication can "create false and undesirable misapprehensions."[32] There was a recommendation that leading cases should be reported as as case studies. However some felt that Lord Hunt's proposed "FOSBOOK" in which cases would be reported will amount to "second tier regulation".[33]

Thefrefore, the practice of only reporting on findings in general and also anonymous is very different from the South African practice of making full judgments available to members of the public.[34]

3. Jurisdiction of the Ombud

The matter of reporting brings a second issue to the fore, and that is the jurisdiction of the FAIS Ombud. In the recent decision of the Appeal Board of the Financial Services Board in

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[29] Lord Hunt *Opening up, Reaching out and Aiming High: An Agenda for Accessibility and Excellence in the Financial Ombudsman Service* (2008).

[30] *ibid* 50.

[31] *ibid.*

[32] *ibid.*

[33] Blackmore "AIFA fears second tier regulation via FOSBook" (2008) *Moneymarketing* http://www.moneymarketing.co.uk/analysis/aifa-fears-second-tier-regulation-via-fosbook/165002.article (01-07-2011).

[34] See para 3.4.3 below.

Sharemax Investments (Pty) Ltd (in business rescue) and Others v Siegrist and Another,[35] the Appeal Board ruled that the FAIS Ombud erred in joining Sharemax and four of its directors in a complaint procedure that was brought by two complainants, Siegrist and Bekker, against two financial advisors who advised the complainants to invest in the Sharemax-promoted Zambesi syndication. The Ombud, on her own initiative, decided to join Sharemax and four of its former and present directors as defendants because she regarded them as “interested parties” as described in section 27(4) of the FAIS Act. She subsequently denied the directors’ leave to appeal against the decision and when the Appeal Board agreed to hear the appeal, the issue of jurisdiction was one of the matters that was unpacked. The Appeal Board re-iterated that neither section 27(4) nor any other provision in the FAIS Act or the rules that have been promulgated in terms of section 26(1) provides the Ombud with the power to join a defendant.[36] The Appeal Board states very clearly that the complaint before the Ombud is the only issue that should be determined. It is not the Ombud’s task to police financial services providers[37] and consequently the appeals were upheld and the orders against Siegrist and Bekker set aside.

4. Fairness *and* law

To return to the issue of fairness: Although the Ombud must make a decision that is fair to all the parties involved, that does not mean that the Ombud should have a blatant disregard for South African law. In fact, the Appeal Board in *Sharemax Investments* found it disturbing that the Ombud was of the opinion that common-law principles have no place in proceedings before her.[38] Although the *Sharemax Investments* case is fundamentally about jurisdiction and the Ombud’s powers, it is very important to note that the Appeal Board also states that where there is a matter before the Ombud and it is based on the breach of a statutory duty, common-law principles apply. Similarly, where a matter hinges on breach of contract or delict, the Ombud should also have regard to common-law principles. Unfortunately the rather short decisions by the Ombud often set out the facts and the decision, together with the relevant statutory principles, but all too often there is only mention of breach of the GCC and no investigation into matters such as breach of contract or negligence. The brief exposition below picks up on this issue.

[35] FAIS 00039/11-12/GP1 and FAIS 06661/10-11/WC1 of 13 April 2015.

[36] *Sharemax Investments* at paras 49 and 52.

[37] *Ibid* para 16.

[38] *Ibid* para 19.

5. FSR Bill

Among the many objectives of the FSR Bill there are specific ones that are aimed at providing for a more effective council for financial ombud services and for the council to oversee the ombud schemes. In addition, the Bill aims to provide for the "recognition of recognised schemes",[39] to lay down minimum requirements for schemes,[40] to promote financial customer education with regard to schemes,[41] to co-ordinate the activities of ombuds of recognised schemes with the activities of the statutory ombud schemes and to develop and promote best practices for complaint resolution.[42]

It is not clear how the Council who is to oversee the Ombud will make much of a difference. From the *Sharemax* debacle it is evident that the Appeal Board is currently equipped to overrule an inaccurate decision by the Ombud. In actual fact, the current appeal procedure should be more than adequate to ensure fairness in all respects. However, a closer look at the FSR Bill reveals a total overhaul of the current system. The Financial Services Ombuds Schemes Act[43] will be repealed and integrated in the FSR Bill in such a way that the Financial Services Ombuds Schemes Council (FSOS Council) will have the power to consolidate and streamline ombuds arrangements more effectively. All existing ombuds will however remain in place and will continue to function, but the FSOS Council will promote and direct co-operation and co-ordination of the activities of the schemes to achieve an overarching and unified complaint-resolution service for consumers. Clause 168 of the revised FSR Bill contains the new statutory provisions pertaining to the Council.[44] The functions of the Council are provided for in clause 176 and this provision stipulates *inter alia* that the Council, in consultation with the relevant ombud, should develop and promote best practices for complaint resolution by a particular scheme.[45] According to clause 176(2)(a), the Council must ensure that a council standard does not impede the independence of an ombud, or interferes with the investigation or determination of a complaint.

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[39] Preamble to the FSR Bill.

[40] *ibid.*

[41] *ibid.*

[42] *ibid.*

[43] 37 of 2002.

[44] Clause 168 provides as follows: "(1) The Financial Services Ombud Schemes Council that was established in terms of section 2 of the Financial Services Ombud Schemes Act, 2004 (Act No. 37 of 2004), continues in existence. (2) The Council is an independent body that has the powers and duties, and performs the functions, that are set out in this Act. (3) The Council is directly accountable to the Minister."

[45] Clause 176(1)(d).

Another change that will be introduced is that there will be an office of the Ombud for Financial Services Providers and the office of the adjudicator.[46] Clause 180 stipulates that the objective of the Adjudicator and the Ombud for Financial Services Providers is "to consider and dispose of complaints in their respective spheres in a procedurally fair, informal, economical and expeditious manner and by reference to what is equitable in all the circumstances". In doing so, they should have regard to the contractual arrangement or other legal relationship between the complainant and any other party to the complaint and the provisions of the FSR Bill, any other applicable law, conduct standard, codes of conduct, pension fund rules and rules of practice. These two spheres referred to are financial services as currently described by the FAIS Act on the one hand and pensions on the other hand.

Especially in the sense that the Adjudicator and Ombud should have regard to fairness, the relationship between the parties and the law, the FSR Bill seems to echo what is already contained in the FAIS Act and what has been blatantly disregarded by the FAIS Ombud in *Sharemax*. What is innovative though is that the revised FSR Bill imposes a duty on the regulators to co-operate with the Financial Intelligence Centre and otherwise assist in preventing and combating financial crime. Furthermore, clause 77 of the FSR Bill stipulates that the financial sector regulators and the Financial Intelligence Centre must enter into an agreement in respect to how they will co-ordinate the performance of their functions in terms of the Financial Intelligence Centre Act.[47]

The problem with determinations as precedents have not been addressed by the FSR Bill. Section 186(1)(b)(iv) stipulates that the Ombud may make any other order which a court may make.

6. More of the same?

6.1. General

An overview of the activities of the FAIS Ombud for 2014 reveals that a variety of complaints were heard. Some of these dealt with important legal issues and considerations other than fairness should ideally have informed these issues. A summary of some of these cases will be given to illustrate this point.

[46] Clause 177.

[47] Act 38 of 2001.

6.2. Services under supervision and vicarious liability

In *Judith Augusta Theophiel Eduard Campioni-De Vleesshauwer v Suzette Brickhill and Mathys Johannes Marais t/a Protea Makelaars*[48] and *Auberge Guest Lodge CC v Suzette Brickhill and Mathys Johannes Marais t/a Protea Makelaars*[49] the Ombud ruled that Brickhill breached section 2 of the GCC because she failed to act with due skill, care and diligence and in the interests of clients and the integrity of the financial services industry. Brickhill rendered services under supervision and she had been in the employment of Marais (Protea Makelaars) since 1 May 2001. Despite Marais visiting Brickhill every six to eight weeks and performing an annual audit, Brickhill managed to defraud the two complainants in question. Brickhill persuaded new clients to pay annual premiums on their policies. She provided them with false invoices on Protea's letterhead. Brickhill did not keep these files in her office and Marais was ignorant of her activities. When he discovered her deceit, he immediately dismissed her. The Ombud had to decide two issues, namely whether there was sufficient evidence to find that Brickhill breached her duties in terms of the GCC by acting dishonestly and whether this caused the complainants in both cases to suffer financial loss. The second question was whether both Brickhill and Marais should be held liable.

The Ombud found that both complainants transferred their "annual premiums" to Brickhill. Neither Brickhill nor Marais had a mandate to collect premiums on behalf of Santam. Furthermore, the Ombud found on the facts that Marais allowed Brickhill to render financial services to the public whilst not being registered with the Registrar as his representative in terms of section 13 of the FAIS Act. Brickhill's rendering of services to the public was therefore not only a matter of her violating the law but also a transgression by Marais. Brickhill was not allowed to render services without supervision and that constituted a failure on Marais' behalf. As part of his ongoing obligation to supervise Brickhill, Marais should also have ensured that she complied with the General Code of Conduct as required in terms of section 13(2)(b) of the FAIS Act. Accoring to the Ombud, his failure to utilise resources, procedures and technological systems efficiently to prevent harm to clients renders him liable. In both cases, the Ombud found that Brickhill rendered her services to the public for an on behalf of Marais and it was in the course and scope of her employment that Brickhill misappropriated insurance premiums. For these reasons the Ombud determined that Brickhill and Marais jointly and severally liable to the complainants.

In this particular instance the Ombud's decision cannot be faulted, as services under supervision plays an important role in the insurance industry. Those representatives who do not meet certain of the competency requirements must render services under the guidance,

[48] Case number FAIS 04437/11-12/lp 3.

[49] Case number FAIS 05228/11-12/MP 3.

instruction and supervision of a supervisor.[50] The rights and duties of the supervisor is accordingly specified. As far as the law is concerned, this particular case is an example of where a court would have determined the issue not only on the stipulations of eth FAIS Act but also on the employer-employee-relationship that gives rise to vicarious liability. Matters such as the relationship between the parties (being one of employer and employee), the fact that Brickhill had possibly committed a delict and the question whether she had acted in the scope of her employment are matters that would have been debated. Therefore, although the outcome of the two decisions in question were satisfactory, a proper exposition of Marais' direct and possibly vicarous liability would have been instructive. This proves the point that although decisions such as these are fair, they should not be usd as precedents. Unfortunately the FSR Bill does not change this.

6.3. *Incidentalia* of insurance contracts and the duties of advisors

The proverbial devil is in the detail and because insurance is complex, prospective policyholders should ensure that they read an offer and acquaint themselves with the details before they enter into an insurance contract. Because of the asymmetry of information, there is a duty on intermediaries to explain the terms of the policy they are about to procure. Onerous clauses are particularly problematic. In *Fliptrans CC v S & P Insurance Advisors (Pty) Ltd t/a McCrystal and Partners and E Solmes,*[51] the dispute between the complainant and the respondents stem from the repudiation of a claim in terms of a short-term policy with New National. The policy was for the insurance of the complainant's motorcycle. The motorcycle was stolen on 9 July 2013 and the theft was reported to the respondents, S & P Insurance Advisors (Pty) Ltd t/a McCrystal and Partners and Elton Solms, the director of the first respondent. Essentially, the complainant's complaint is that the respondents as intermediaries failed to inform the complainant that the motorcycle had to be fitted with a tracking device. As a result, the complainant failed to fit such a device and this failure was the reason for New National's repudiation of the claim. In other words, had the complainant's attention been drawn to this particular requirement in the policy, he would have fitted the device and the claim would have succeeded. Accordingly, he would not have lost R79 500 which was the value of the motor cycle at the time of the loss.

The question *in casu* is essentially whether the respondent had failed in his duties as set out by section 7(1)(c)(vii) of the GCC. This sbsection stipulates that a provider other than a direct marketer must provide, at the earliest possible opportunity, "concise details of any special terms or conditions, exclusions of liability, waiting periods, loadings, penalties,

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[50] Board Notice 104 of 2008.

[51] Case number: FAIS 07987/11-12/GP3.

excesses, restrictions or circumstances in which benefits will not be provided." Insurance contracts are mosty standardised. Those who provide advice and intermediary services or at least earn commission for selling insurance, has a duty to perform in terms of their mandate. In this particular case, the facts revealed that the insurance that was sold to the respondent was in fact incidental to the sale of his motor cycle and the respondent was in actual fact not involved in the transaction. He definitely did not provide advice and did not explain those onerous clauses in the contract.

This particular determination is no doubt fair. It follows other determinations such as *Susanna Aletta Grobler v Direct Axis (Pty) Ltd*[52] and re-iterates the fact that intermediaries must sing for their supper. However if one considers contract law and what constitutes consensus between the parties, several legal issues come to the fore. While the determination satisfies one's sense of fairness, there are several issues pertaining to *consensus,* pro-forma type contracts and vagueness of contractua terms that could have been better explained. Again, a determination such as the one in Fliptrans should not have been a precedent but could at the most have been presented as an example of what is expected of an insurance broker when selling a motor policy.

The exact same clause of the GCC was the subject of discussion in *Andrew Graham Stunden and Nicolaas Leon van der Walt t/a Investment & Insurance Brokers.*[53] *In casu* the complainant was the owner of a house in Knysna. The respondent is an insurance broker and a sole proprietor trading as Investment and Insurance Brokers. The respondent personally rendered financial services to the complainant and on the former's advice, he place his motor and household contents cover with Santam in 1999. When the complainant moved into a new house in June 2004, he again consulted with the respondent. He informed the respondent that his home had burglar bars on the ground floor windows only and that a linked alarm would be installed the following week. The respondent noted this and then proceeded to note the installation of the alarm the following week. The respondent and complainant met anually to adjust the insured values and other changes to the policy.

In July 2009 the insurer issued a notice to all brokers informing them that with effect from 1 September 2009, that the security measures in the Knysna area will be burglar bars and security gates as well as a linked alarm. This notice further states that Santam experienced a high claims rate and urged brokers to infom their clients that alarms needed to be fitted. The complainant suffered a burglary at his home on 5 June 2010 and at the time, only the ground floor windows were potected by burglar bars. The house was also protected by an alarm linked to an armed response. Santam established that the burglars gained

[52] Case number FOC 1434/05 NP 2.

[53] Case number FAIS 01993/11-12/WC 3.

access to the house through a top-floor window by using a long ladder. The window was not protected by burglar bars. The alarm was triggered when the burglary took place but the buglars escaped. The complainant's claim to Santam was rejected because he did not comply with the minimum security requirement of burglar bars on all windows. The essential question was whether the Respondent's conduct amounted to a contravention of the FAIS Act and the GCC and if so, whether this caused the complainant to suffer financial prejudice. The Ombud determined that theer was in fact a contravention of the GCC as the respondent knew about the insurer's new requirements but had in fact failed to convey the information to the complainant. What makes this determination different from the one in *Fliptrans* is that this case dealt with an existing contract for short-term insurance that had been in place for some time. The insurance company changed their requirements pertaining to burglar bars and the broker did not convey the information to the complainant. Situations such as these are perhaps not that easily explained in contract law. However, as this additional requirement by the insurer constitues a material change to the contract, it is submitted that it was absolutely essential for the broker to ensure that policyholders were informed of this change. This would have afforded them an opportunity to make an informed decision as to their contunued relationship withj the insurer.

Again, although the Ombud's decision satisfies one's sense of fairness, there are questions on contract law and the variation of contractual terms that are not addressed by this determination. On the facts it is evident that the respondent did not perform his duties as could be expected. It is submitted that a rules-based approach as is proposed by the FSR bill will have an influence on market conduct and that issues such as the non-disclosure of onerus terms will be more important. Matters such as plain language, consumer education and the format in which poicies are presented to clients are expected to become more important and TCF outcomes will influence traditional contract theory as we know it.

7. Conducting business without a license

A recurring problem in the insurance industry seems to be the conducting of business without a licence. A person may not act or offer to act as a financial services provider unless such person has been issued with a licence in terms of section 8 of the FAIS Act.[54] Key to the granting of a licence is the question whether the applicant complies with the requirements of fit and proper in accordance with the category of FSP. The Registrar must consider issues such as operational ability, financial soundness and whether the key individual meets the characteristics of honesty and integrity.

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[54] Moolman (n 25) 17.

In *The Reformed Christians for Truth Church v Merit Legal and Funeral Cost Assistance (Pty) Ltd and Moeti Michael Matlaupane*[55] the complainant, represented by Pastor Paul Teko Mosadi, entered into an agreement in terms of which the respondent had to provide certain funeral benefits to members of the congregation against payment of a monthly premium. At the outset of the respondents' dealings with the complainant, the respondents informed the complainants that the first respondent was underwritten by the South African Insurance Company (SAFRICAN) and that the first respondent was duly licensed by the Financial Services Board (FSB) in terms of the FAIS Act to render financial services to the public. The first respondent cited their registration number as 15123. In fact, this registration number belongs to SAFRICAN and the first respondent was not ever licensed to conduct insurance business. The parties agreed that the claimant would be paid within a period of 48 hours after lodgement of a claim. The complainant paid the respondent the agreed monthly premiums. During December 2012, one of the complainant's congregants passed away. When no paymant was forthcoming, the complainant's investigation revealed that there was never any insurance cover.

The Ombud's investigations confirmed that neither the first nor the second respondent were registered with the Financial Services Board and there was no evidence that the second respondent was ever registered as an agent of a financial services provider. The respondent made the statements well-knowing that he was acting illegally and that he had no intention of ever paying on any insurance claim. Therefore, the second respondent's conduct is both illegal in terms of the FAIS Act and it is unlawful in terms of common law. It seems that despite the strict regulatory environment, dishonest charlatans still manage to con members of the public.

In the same vein but pertaining to short-term insurance, some 22 determinations were made against Pieter De Wet t/a Model Insurance Company, the first of which was made in favour of Melvin Shane Creswell.[56] Mr Creswell is one of a number of policy holders who approached the Ombud's office because the respondent failed to honour their claims. It appears that the respondent, Pieter de Wet t/a Model Insurance Company, presented himself to members of the public as as an authorised short-term insurer and he collected premiums from non-suspecting consumers such as the complainant. The Registrar of Short-term Insurance (Registrar) confirmed that the respondent had never been licensed in terms of section 7(1) of the FAIS Act to render financial services to the public. He had also never

[55] Case number FAIS 08606/12-13/NW 2.

[56] Case number FSOS 00184/11-12/KZN(3).

been licensed to conduct business as a short-term insurer as stipulated by section 7 of the STIA. This particular section stipulates as follows:

> "(1) No person shall carry on any kind of short-term insurance business unless that person –
>
> (a) is registered or deemed to be registered as a short-term insurer, and is authorised to carry on the kind of short-term insurance business concerned under this Act; or
>
> (b) is authorised under section 56 to do so, and carries on that business in accordance with this Act."

The Registrar issued a warning during February 2012 and warned the public requesting the public not to do business with Model and this particular saga is an example of where there is already a measure of information-sharing between the Registrar and the FAIS Ombud and of how the current FSB and the FAIS Ombud do have the opportunity to co-operate in a way that is not to the detriment of complainants or respondents but can in fact prevent members of the public from suffering financial prejudice. The respondent ignored this warning and continued to do insurance business without a license. The Registrar then reported the respondent to the Commercial Crime Branch of the South African Police Service. In addition, the Registrar obtained an interim interdict in the Kwazulu-Natal High Court to stop the respondent from carrying out short-term insurance business.

The outcome of all these case were basically the same, namely that it was evident that the respondent carried on regardless of the Registrar's warnings. This caused financial prejudice to all the complainants involved.

Of course, in all the cases where members of the public were conned by unlicensed financial services providers, these complainants benefited from approaching the FAIS Ombud because their complaints could be dealt with expeditiously. Had court procedures been their only hope of claiming their losses, these procedures would have been costly and would in all likelihood have been delayed because the court rolls are so full. The Ombud serves a clear purpose here. Furthermore, the Ombud is in an ideal position to notify the Registrar as soon as it becomes evident that someone such as Pieter de Wet is providing financial services illegally. This is perhaps one of the greatest advantages of having a dedicated, alternative dispute resolution system such as the FAIS Ombud.

8. Conclusion

It is expected that the enhanced oversight of ombud schemes as envisaged by the FSR Bill has the potential to adddress some of the challenges in insurance market conduct. These include stronger powerd of the FSOS Council to consolidate and streamline Ombud determinations more effectively.[57] Fairness has from the outset been one of the criteria for

[57] National Treasury *Twin Peaks In South Africa: Response and Explanatory Document Accompanying the Second Draft of the Financial Sector Regulation Bill* (December 2014) 14.

decisions by the FAIS Ombud and even though the ombud determinations do not always deal with points of law in a very satisfactory way, many determinations do enforce the right of consumers of insurance products. Other than the streamlining of Ombud determinations an oversight by the new FSOS Council, it seems that nothing much will change on this front with the introduction of the FSR Bill. Ombud determinations will still have the effect of court judgments and these will still be reported as precedents.

PART III: PRUDENTIAL AUTHORITY

1. Background

Generally speaking, prudential regulation and supervision aim to promote financial system stability and issues such as the solvency and liquidity of financial institutions are the focus of this function.[58]

One of the many functions of the prudential authority will be to undertake administrative and enforcement action as per chapters 12 and 13 of the FSR Bill and "administrative action" has the meaning defined in section 1 of the Promotion of Administrative Justice Act.[59] Chapter 13 of the FSR Bill sets out the powers of financial authorities to institute administrative action and according to clause 147*(a)* of the Bill.

The Promotion of Administrative Justice Act applies to any administrative action taken by a financial sector regulator in terms of this Act or a financial sector law, subject to paragraph (c) and paragraph (c) specifies that there may be different procedures for any specific administrative action provided that those procedures are fair, reasonable and justifiable in the circumstances.

There are further obligations on financial sector regulators to "put in place and maintain effective arrangements for taking administrative action that are consistent with the FSR Bill, "the Promotion of Administrative Justice Act, and the requirements of the other financial sector laws, which arrangements must include the adoption of administrative action procedures, and may include the establishment of an administrative action committee and other measures."[60]

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[58] National Treasury *Explanatory Document* (n 58) 10.

[59] 3 of 2000. This statute defines "administrative action" means any decision taken, or any failure to take a decision, by –(a) an organ of state, when – (i) exercising a power in terms of the Constitution or a provincial constitution; or (ii) exercising a public power or performing a public function in terms of any legislation; or (b) a natural or juristic person, other than an organ of state, when exercising a public power or performing a public function in terms of an empowering provision, which adversely affects the rights of any person and which has a direct, external legal effect".

[60] Clause 147(b).

It is foreseen that enforcement actions will mainly deal with the issuing of directives, entering into enforceable undertakings, declaring practices as undesirable, applying to court for appropriate orders and imposing an administrative penalties. Where the focus in the past have perhaps been more on penalties, that has now shifted and the FSR Bill states that remediation aims to rectify the breach and ensure it does not recur. In addition, and according to the principles of the promotion of administrative justice, chapter 15 sets out a strong appeal mechanism. Therefore, if the prudential authority detects a breach of a financial sector law, including of a prudential or conduct standard, it can choose to take remedial or punitive action. The FSR Bill provides the power to issue directives, enforceable undertakings, interdicts, debarment orders, and to impose administrative penalties.

These powers are not new to the regulatory authorities, and for the most part are a familiar feature of financial sector laws but it is expected that administrative functions will be harmonised by the new legislative dispensation. Currently, the FAIS Act contains detailed sections on offences and the payment of penalties which may be imposed by the Registar of the FSB. Any financial services provider that does not comply with its statutory duties may be penalised and this function of the FSB is exercised by the Enforcement Committee. This Committee, which is an administrative body established in terms of the Financial Services Board Act 97 of 1990, is empowered to impose unlimited penalties, compensation orders and cost orders and its determinations are enforceable as if it were a judgment of a court of law. The policing of the industry remains an important function and the FSR Bil provides inter alia for enforcement powers, the establishment of the Financial Services Tribunal, procedures for taking decisions as well as for the appeal of these decisions.

According to National Treasury, clear, transparent, fair enforcement mechanisms are a crucial part of an effective financial regulatory system. A Financial Services Tribunal is established to support fair administrative action and enforcement by the authorities. It is however not only the structure that will be reformed, but also the *nature* of regulation, supervision and enforcement. Therefore, the new authorities "will be more proactive and intrusive in their supervision, and more principles-based in taking action where necessary."[61]

As far as administrative actions are concerned, the actions described below show that the Enforcement Committee usually acts where there is breach of a particular rule. The FSR Bill however envisages for the new authority to "act decisively where necessary, at times on the basis of judgement rather than a formal 'breach' of a specific rule."[62]

Therefore, the new difference between remedial and penalty actions are perhaps a more innovative approach than the current approach and directives and enforceable

[61] National Treasury *Explanatory Document* (n 58) 39.

[62] *ibid.*

undertakings now also form part of the proposed new legislation. Where directives have been issued before, enforceable undertakings (EUs) are a new instrument for most sectors, although they have been introduced in the Financial Services Board Act recently. Clause 142 of the FSR Bill stipulates that a financial sector regulator may accept a written enforceable undertaking by a person in relation to any conduct engaged in by the person in respect of which the financial sector regulator has a function in terms of a financial sector law. The person may, with the regulator's consent, withdraw or vary the undertaking at any time.[63] The crux of the concept legislation is found in clause 142(3) which stipulates as follows:

> "(3) If the financial sector regulator considers that the person who gave the undertaking has breached a term of the undertaking, the Financial Sector Regulator may:
> (a) impose an administrative penalty;
> (b) apply to a Court for an order directing that person to comply with the terms of the undertaking, or any other order the Court considers appropriate; or
> (c) in the case of a licensed financial institution, suspend or withdraw the licence of the financial institution."

Furthermore, clause 142(4) holds that an enforceable undertaking must be made public by the financial sector regulator in a manner that the financial sector regulator determines is appropriate. The purpose of the new rules pertaining to an enforceable undertaking is that it provides the regulator with broad corrective powers under an agreement with the wrongdoer. It is expected that enforceable undertakings will set out detailed steps for correcting a deeply flawed aspect of a financial institution's process or system.

Court orders by the High Court to compel a financial institution to comply with a financial sector law, to compel compliance with a rule, directive or lawful request remain part of the new prudential authority's armour.

What is different under the new Twin Peaks legislation is the new Financial Services Tribunal. The Tribunal's powers is set out in chapter 15 of the FSR Bill and clause 145 stipulates that the function of the Tribunal is to hear and decide appeals by persons aggrieved by a decision of a decision-maker in terms of a financial sector law.The Tribunal may also order a party to the appeal to pay some or all of the costs incurred by the other party. An order by the Tribunal has legal force, and may be enforced as if it were issued in civil proceedings in a division of the High Court.[64]

[63] Clause 142(2).

[64] National Treasury *Explanatory Document* (n 58) 42.

2. Recent enforcement actions

Over the past year, enforcement actions pertaining to insurance products were mostly satisfactory. Determinations included *The Registrar of Financial Services Providers v Finstate CC.*[65] *In casu* the Registrar's action against Finstate is based on two contraventions. The first is a contravention of section 13(2)(a) of the FAIS Act and the second a contravention of section 12(c) of the GCC. The parties agreed that both these provisions were contravened and the agreed penalty was R40 000. More specifically, in this particular enforcement action, some of Finstate's representatives rendered financial services during October 2011 and October 2012 in respect of health services benefits from Discovery. These representatives were not competent to render these services because they were not duly accredited in terms of regulation 28 B of the Medical Schemes Act 131 of 1998.

Section 13(2)(a) of the FAIS Act reads as follows:

> "An authorised financial services provider must at all times be satisfied that the provider's representatives, and the key individuals of such representatives, are, when rendering a financial service on behalf of the provider, competent to act, and comply with the requirements contemplated in paragraphs *(a)* and *(b)* of section 8(1) and subsection 1*(b)*(ii) of this section, where applicable."

The reference to section 8(1) is to the fit and proper requirements, which entail that financial services providers must comply with the characteristics of honesty and integrity, competence, operational ability and financial soundness. The second charge pertaining to the contravention of section 12(c) of the General Code of Conduct entails Finstate's failure to structure its internal control procdures "so as to provide reasonable assurance that all applicable laws were complied with."[66] Failure to do so resulted in a contravention of section 13(2)(a) of the FAIS Act.[67]

In *The Registrar of Short-term Insurance v The Lawyers Voice (Pty) Ltd*[68] there was a contravention of section 7(1)(a) of the Short-term Insurance Act 53 of 1998. This particular section provides that "no person shall carry on any kind of short-term insurance business, unless that person is registered or deemed to be registered as a short-term insurer, and is authorised to carry on the kind of short-term insurance business concerned, under this Act."

Where some contraventions are not so serious and does not cause harm to consumers of financial products, others have more serious implications. In *The Registrar of*

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[65] Case number 12/2013. For a discussion of the case, see Millard *Juta's Insurance Law Bull* vol 17 no 1 (2014) 1.

[66] *ibid* 1-2.

[67] *ibid.*

[68] Case number 09/2013.

Short-term Insurance v Santam Ltd[69] Santam authorised a small number of collecting agencies to collect premiums for short-term policies (personal lines) on its behalf between November 2008 and March 2013. In doing so, Santam contravened several legislative provisions, including Directive 156.A.i (ST) read with section 4(2) of the Short-term Insurance Act, section 45 of the Short-term Insurance Act and regulations 4.1(1) and 4.1(2) of the Regulations in terms of the Short-term Insurance Act. In addition, Santam failed to use the prescribed method in the Short-term Insurance Act to calculate its unearned premium provision for its crop insurance class (this particular contravention is of an actuarial nature and will not be discussed here). The parties agreed that Santam would pay a fine of R200 000.[70]

The essence of the contravention is found in section 45 of the Short-term Insurance Act which states as follows:

> "No independent intermediary shall receive, hold or in any other manner deal with premiums payable under a short-term policy entered into or to be entered into with a short-term insurer, other than a short-term reinsurance policy, and no such short-term insurer shall permit such independent intermediary to so receive, hold or in any other manner deal with such premiums—
> (a) unless authorised to do so by the short-term insurer concerned as prescribed by regulation; and
> (b) otherwise than in accordance with the regulations."

Regulation 4.1(1) stipulates that a short-term insurer should authorise a collecting agency in writing to receive, hold or deal with premiums on its behalf and regulation 4.1(2) requires an insurer to obtain securities from the collecting agencies. Not only did Santaim fail to provide written authorisation to these collecting agencies and to obtain securities but it also failed to furnish the Registrar with proof of the written authorisation and securities in accordance with section 4(2) of the Short-term Insurance Act. This particular section, read with Directive 156.A.i (ST), instructs short-term insurers to provide the Registrar with an action plan to rectify the non-compliance with section 45 within 15 days from the date of informing the Registrar.[71]

This particular transgression highlights the important role of the Registrar in protecting the interests of policyholders and it illustrates the need for proper compliance measures. Because the collection of premiums is a core function of insurance business, it cannot be entrusted to just anybody and if a third party is entrusted with the collection of premiums, it is essential that that agreement complies with the stipulations of the Short-Term

[69] Case number 11/2013.

[70] *Juta's Insurance Law Bull* (n 66) 3-4.

[71] *ibid.*

Insurance Act 53 of 1998. This is an example of where the Enforcement Committee acted to penalise breach of a particular statutory provision.

In *The Registrar of Financial Services Providers v Hippo Comparative Services (Pty) Ltd,*[72] the respondent, through its call centre, provided financial services to members of the public betweeen 19 April 2011 and 7 September 2012. These services included the selling of short-term insurance policies on behalf of various short-term insurers. As part of these services the call center agents were also required to provide clients with different insurance quotations before selling a particular product. Unfortunately the call centre failed to provide clients with the complete lists of generated quotations and in some cases only provided clients with the cheapest quotations. This particular *modus operandi* resulted in "an approach in terms of which, in some cases, preference was given to the quantity of business over the quality of service rendered to clients."[73] The parties agreed that the respondent's behaviour constituted a contravention of section 3A(1)(b)(i) of the General Code of Conduct.[74] In addition to the contravention of section 3A(1)(b)(i), it was also found that there was a contravention of section 15(1) of the General Code of Conduct. This particular section stipulates as follows:

> "A direct marketer must, when rendering a financial service to or on behalf of a client, at the earliest reasonable opportunity furnish the client with the following particulars:
> (a) the business or trade name of the direct marketer;
> (b) confirmation whether the direct marketer is a licensed financial service provider and details of the financial services which the direct marketer is authorised to provide in terms of the license and any conditions or restrictions applicable thereto;
> (c) telephone contact details of direct marketer (unless the contact was initiated by the client);
> (d) telephone contact details of the compliance department of the direct marketer;
> (e) whether the direct marketer holds professional and indemnity insurance".

The respondent failed to inform clients that it was a financial services provider. In addition, clients were also not informed of the details of the financial services that the respondent was authorised to provide and whether it held professional indemnity insurance. Its legal status and relationship with the various short-term insurance providers were also not disclosed. A penalty of R1 500 000 was imposed.[75]

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[72] Case number 08/2013.

[73] See *Juta's Insurance Law Bull* (n 66) 6-7.

[74] Section 3A "Financial interest and conflict of interest management policy" came into effect on 19 April 2011. Section 3A(1)(b)(i) holds that a provider may not offer any financial interest to a representative of that provider for giving preference to the quantity of business secured for the provider to the exclusion of the quality of the service rendered to clients.

[75] *Hippo Comparative Services* at para 5.

3. Evaluation

It is suggested that overall, the Enforcement Committee's activities are already aimed at deterring financial services providers by imposing administrative penalties. Just administrative action is evident from the composition and activities of the Enforcement Committee and harsh penalties serve to protect the interests of consumers of financial services. Overall, the changes envisaged by the FSR bill is not expected to have much of an impact on insurance companies. Enforcement Action has been successful without too much bureaucratic red tape. More intergation and information sharing are matters that will be addressed by the Twin Peaks Bill.

PART IV: COMMON LAW, INSURANCE LEGISLATION AND THE PRODUCT LIFE CYCLE

As was stated above, the current dispensation for insurance allows for common-law principles as well as legislation and products are grouped together as either short-term insurance or long-term insurance. Reinecke *et al* refer to this division as "curious and anachronistic".[76] Matters were definitely complicated by the introduction of a special dispensation for insurance (and other) intermediaries and advisors by the FAIS Act and as was argued above, the way in which the Ombud applies principles pertaining to fairness have definitely had implications for the way in which ordinary contractual principles are applied. The new dispensation is expected to muddle matters even further. Once TCF principles have become part of the new regulatory framework, courts will have to take this into account in deciding matters. This means that it will no longer be sufficient to apply the law, but courts will also have to measur eteh conduct of contracting parties against the TCF outcomes and in light of the product-life cycle. It is suggested that it will no longer be possible to only consider the policy document as the record that sets out he rights and duties of the parties but that aspects such as the way in which the product was advertised and sold will now also have to be considered.

Not only the TCF Principles but also matters such as disclosure of product information, claims handling, product standards and complaints that resor under market conduct will no doubt be more consumer-oriented. It is an open question how courts will interpret TCF principles in disputes on insurance. It is not sure when the FSR Bill will become law. However it is suggested that in the absence of new insurance legislation there will be interpretational issues that will make for some interesting reading.

The role of the courts in adjudicating insurance matters remains the same in the sense that any aggrieved party may approach a civil court with a dispute. An overview of

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[76] Reinecke, Van Niekerk and Nienaber *South African Insurance Law* (2013) 10.

the past year's cases reveal that recussing issues remain misrepresentation and the duty to disclose (*Visser v 1 Life Direct Insurance Limited,*[77] *Valoyi v Absa iDirect Limited*[78] and *Regent Insurance Co Ltd v King's Property Development (Pty) Ltd t/a King's Prop*).[79] In addition, a number of cases addressed issues on the *incidentalia* or what is sometimes perceived as unfair, hidden clauses in insurance contracts cause costly litigation. There are many examples of *incidentalia* in insurance contracts such as forfeiture clauses in the instance of fraud (see *P K Harikasun v New National Assurance Company Ltd*[80] The effect of a condition precedent was the topic under discussion in *Screening and Earthworks (Proprietary) Limited v Hollard Insurance Company Limited.*[81]

However it is suggested that the way in which the courts will apply the law as well as fairness principles is an open question. Insurance remains complex and can only be simplified to a certain extent. Although the FAIS Ombud will be in a position to adjudicate on matters pertaining to insurance that concern the conduct of intermediaries and advisors, disputes between policyholders and insurance companies on matters such as those that have been mentioned in the previous paragraph still involve civil courts. It is not at all sure whether the principles that underlie current insurance law can always be related to an existing legal principle (statutory or otherwise).[82]

It remains to be seen how courts will apply the law as well as fairness principles. Insurance remain complex and can only be simplified to a certain extent. Although the FAIS Ombud will be in a position to adjudicate on matters pertaining to insurance that concern the conduct of intermediaries and advisors, disputes between policyholders and insurance companies on matters such as those that have been mentioned in the previous paragraph still involve civil courts.

The remaining question that needs to be asked is whether the principles that underly current insurance law can be related to an existing legal principle (statutory or otherwise).[83] In order to answer this question, one should start by viewing the product-life cycle of a financial product. TCF holds that the real question whether a client has been treaed fairly should always be answered by viewing the steps in the life cycle and these are as follows,

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[77] Unreported, referred to as [2014] ZASCA 193, 28 November 2014.

[78] (ZAGPPHC) 12 June 2014 (case 27970/2011).

[79] 2015 3 SA 85 (SCA).

[80] (KZN) 12 December 2013 (case 190/2008).

[81] (ZAGPJHC 76) 4 April 2014 (case 2008/27712).

[82] On the impact of TCF on insurance contracts, see Millard (n 18) 547-566.

[83] On the impact of TCF on insurance contracts, see Millard D "Through the looking glass: Fairness in Insurance contracts – A caucus race? *Journal of Contemporary Roman-Dutch Law* 547-566.

namely product service and design, promotion and marketing, advice, point of sale, information after point of sale and complaints handling.[84]

As ar as product service and design is concerned, a clear legal framework as set out by the product-specific legislation (i.e. the LTIA and the STIA) is key. Currently, these two statutes set out the definitions of products and prescribe the rules that are applicable. For instance, “assistance policy” means a life policy in respect of which the aggregate of the value of the policy benefits, other than an annuity, to be provided (not taking into account any bonuses to be determined in the discretion of the long-term insurer) and the amount of the premium in return for which an annuity is to be provided, does not exceed R18 000, or another maximum amount prescribed by the minister; and includes a re-assurance policy in respect of such a policy.[85] According to Reinecke *et al*, an assistance policy may be described as a mini life policy.[86] They argue that the prudential regulation applicable to insurers registered for assistance business is less onerous than for other business because those insurers are not permitted to issue policies with higher sums insured than those prescribed by statute.[87] Setting a maximum on the amount payable in terms of a funeral policy is an example of how product service and design is already regulated by statute. It is expected that in future there will be even stricter product standards. One can therefore safely say that if an insurer issues a policy that is not defined in the enabling legislation, there is prima facie evidence of unfair treatment.

Promotion and marketing as the next stage in the product life cycle may lead to difficulties. Currently, the GCC in terms of the FAIS Act contain standards on advertising of insurance products. Despite this, it may still happen that there is something wrong with the advertisement and that this prompts a client to contact the insurer. The client may find that the product that is offered to the client is not what the advertisement had promised. Although there is still such a thing as offer and acceptance and an insurer is free not to enter into a contract with the insurer, it often happens that where a contract is concluded, a client was promised one thing but then receives something entirely different. This, in all likelihood, amounts to unfair treatment. Again, the current legal framework already addresses this TCF outcome. The GCC defines “advertisement” as

> “any written, printed, electronic or oral communication (including a communication by means of a public radio service), which is directed to the general public, or any section thereof, or to

[84] In general, see Feasibility (Pty) Ltd “Treating customers fairly: A discussion paper prepared for the Financial Services Board” (2010) accessed at www.fsb.co.za on 11 August 2013 and Financial Services Board “Treating customers fairly: The roadmap (2011) (pre-amble) accessed at www.fsb.co.za on 11 August 2013.

[85] S 1 of the LTIA, *sv* “assistance policy”.

[86] (n) 556.

[87] *Ibid.*

any client on request, by any such person, which is intended merely to call attention to the marketing or promotion of financial services offered by such person, and which does not purport to provide detailed information regarding any such financial services."[88]

In addition, section 14 of the GCC contains detailed rules on advertising:

"**14**(1) An advertisement by any provider must-

(a) not contain any statement, promise or forecast which is fraudulent, untrue or misleading;

(b) if it contains-

(i) performance data (including awards and rankings), include references to their source and date;

(ii) illustrations, forecasts or hypothetical data

(aa) contain support in the form of clearly stated basic assumptions (including but not limited to any relevant assumptions in respect of performance, returns, costs and charges) with a reasonable prospect of being met under current circumstances;

(bb) make it clear that they are not guaranteed and are provided for illustrative purposes only; and

(cc) also contain, where returns or benefits are dependent on the performance of underlying assets or other variable market factors, clear indications of such dependence;

(iii) a warning statement about risks involved in buying or selling a financial product, prominently render or display such statement; and

(iv) information about past performances, also contain a warning that past performances are not necessarily indicative of future performances; and

(c) if the investment value of a financial product mentioned in the advertisement is no guaranteed, contain a warning that no guarantees are provided.

(2) Where a provider advertises a financial service by telephone-

(a) an electronic, voicelogged record of all communications must be maintained. Where no financial service is rendered as a result of the advertisement, such record need not be maintained for a period exceeding 45 days;

(b) a copy of all such records must be provided on request by the client or the registrar within seven days of the request;

(c) all the information required by sections 4(1)(a) and (c) and 5(a) and (c) shall not be required: Provided that the client is provided with basic details (such as business name and telephone number or address) of the provider or relevant product supplier, and of their relevant compliance departments: Provided further that, if the promotion results in the rendering of a financial service, the full details required by those sections are provided to the client in writing within 30 days of the relevant interaction with the client.

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[88] S 1 of the GCC, *sv* "advertising".

(3) Where a provider advertises a financial service by means of a public radio service, the advertisement must include the business name of the provider."

This proves that existing law in many cases already contain principles of fairness.

Advice and point of sale may constitute different stages in the product life cycle but more than often these two stages are one and the same thing. "Advice "is already defined in section 1 of the FAIS Act and this particular statute is very clear on the way in which advice should be furnished. In addition to these statutory obligations, there are common law rules pertaining to contract and specifically the duties of insurance brokers that essentially aims to protect the interests of prospective policyholders, thereby enhancing fairness. The duty of a broker to perform the mandate personally, to act with care and skill and to act in good faith are some of the common law duties that still exist.[89] The GCC contains quite a number of detailed rules that stipulate how an advisor and intermediary should conduct himself.

Information after point of sale is the second last stage in the product life cycle. It is submitted that during this stage, it is either the insurer and the policyholder's relationship that is under scrutiny, in which case the LTIA or STIA and the respective PPR's in terms of each applies, or it is the relationship between an insurance broker and a client that is relevant, for instance where the broker continues to render ongoing services. In the latter instance the FAIS Act applies. There are a number of rules that may be identified in terms of the LTIA, STIA and FAIS Act that may apply and that exists to protect the policyholder. For instance, rule 7.4 of the PPR's terms of both the LTIA and the STIA deal with time bar clauses and contain specific provisions on the periods within which a claim can be brought and the time within which a dissatisfied policyholder may bring an action against an insurer. There are many other examples that cannot be discussed here.

The matter of bringing an action brings us to the final stage in the product life cycle, namely complaints handling. Part XI of the GCC in terms of the FAIS act already specifies that and FSP should have an internal dispute resolution system.[90] These and other rules are aimed at treating the customer fairly.

Overall, it is clear that existing common law rules and legislation provide policyholders with a variety of rights. It is suggested that fairness is already infused in insurance legislation and although there are areas such as credit insurance and onerous terms in insurance contracts that need reform, TCF throughout the product life cycle is not really anything new.

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[89] Havenga *The Law of Insurance Intermediaries* (2001) 3 – 4.

[90] See s 19 of the GCC for the specific obligations.

CONCLUSION

Activities of insurers, intermediaries and advisors over the past year reveal the many issues and the complexities that make up insurance business. Insurance as a financial product is complex and as was seen in the FAIS Ombud and Enforcement Committee cases, there is a definite need to promote and enhance consumer protection. It is however anybody's guess whether more bureaucratic arrangements as per the FSR Bill will in fact achieve this objective.

Reckless Credit: Developments regarding affordability assessment and the extended powers of the National Consumer Tribunal[1]

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1 Introduction

Consumer over-indebtedness in the credit market is a global problem. It is detrimental to individual consumers and collectively it can be very detrimental to a country's economy. Many jurisdictions have over the past few decades attempted to find solutions to this problem and have introduced measures aimed at preventing over-indebtedness that operate in tandem with measures providing debt relief to over-indebted consumers. The recent 2008 Global Financial Crisis has renewed the focus on these efforts to curb and remedy consumer over-indebtedness.

The issue of consumer over-indebtedness in the South African credit market has not been a legislative focus area until the introduction of the National Credit Act (herein NCA), which act came into full operation in June 2007. In the pre-NCA regime debt relief for over-indebted consumers was provided by the mechanisms of administration orders[2] which have limited application and the insolvency procedures provided by the Insolvency Act[3], which amongst its many constraints are costly to access but at least holds the promise of debt relief by means of a discharge.

In their endeavours to reform the South African credit market the drafters of the Act recognized the need to *inter alia* address the issue of consumer over-indebtedness by not only 'curing' such over-indebtedness with debt relief assistance but in the first instance by addressing some of the causes of such over-indebtedness. Special emphasis was placed on irresponsible lending practices by credit providers as irresponsible lending is often the root

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[1] This paper is an adaptation and amplified version of the article by Van Heerden and Renke entitled "Perspectives on the South African Responsible Lending Regime and the Duty to conduct Pre-agreement Assessment as a Responsible Lending Practice" *International Insolvency Review* 2015 available at wileyonlinelibrary.com.

[2] As provided for by s 74 of the Magistrates Court Act 32 of 1944. Although the administration process does not expressly compromise the status of consumer-debtors in the manner that insolvency does, one of its main drawbacks is that it does not provide for a discharge after a specified time period with the result that many consumers could stay locked into the administration process for unreasonably long time periods.[2] See further Boraine, Van Heerden and Roestoff 'A Comparison between Formal Debt Administration and Debt Review- the pros and cons of these measures and suggestions for law reform" Part 1 2012 *De Jure* 62 and Part 2 2012 *De Jure* 254.

[3] Act 24 of 1936.

cause of consumer over-indebtedness. In the 2004 Policy framework the drafters of the NCA *inter alia* stated that '[r]eckless credit extension will be curbed by introducing a general requirement that all credit providers should do affordability assessments prior to approving any credit facility'. Addressing irresponsible lending practices inevitably curbs the incidence of consumer over-indebtedness and it is submitted that it should lie at the core of any measures aimed at combating over-indebtedness of credit consumers.

By introducing (for the first time) specific measures expressly aimed at preventing reckless credit granting and providing for debt relief in those instances where reckless credit granting has occurred, the NCA has been aligned with measures in international jurisdictions aimed at preventing and addressing irresponsible lending as a cause of consumer over-indebtedness. This new regime aimed at preventing and addressing reckless credit granting, which has at the date of this contribution been in operation for approximately eight years has undergone a number of significant developments, especially in the last two years. The purpose of this contribution is to provide an overview of the reckless credit regime under the NCA with specific focus on developments regarding affordability assessment and the extended powers of the National Consumer Tribunal with regard to reckless credit.

2 Reckless Credit in terms of the National Credit Act

2.1 Introduction

Reckless credit granting constitutes prohibited conduct in terms of the NCA.[4] The provisions relating to reckless credit granting are contained in Part D of Chapter 4 of the NCA and have no retrospective effect with the result that they apply only to credit agreements that was entered into after the NCA came into operation.[5] These provisions are aimed at addressing reckless credit granting as a cause of consumer over-indebtedness and may only be raised by natural person consumers and only they, and not juristic person consumers (corporate consumers), may access the debt relief offered in respect of reckless credit and over-

[4] The Act however does not classify reckless credit agreements as unlawful as set out in s89.

[5] Item 4(2) of Sch 3 to the NCA. This is due thereto that neither the Usury Act 73 of 1968 nor the Credit Agreements Act 75 of 1980 contained any provisions obliging the credit provider to do a pre-agreement assessment along the lines envisaged by s 81 of the NCA, prior to entering into a credit agreement with a consumer.

indebtedness.[6] Reckless credit granting can be raised in respect of a wide range of credit agreements, secured and unsecured[7] but *not* in respect of a school loan or a student loan; an emergency loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement or a temporary increase in the credit limit under a credit facility.[8]

The National Credit Act identifies and prohibits three types of reckless credit granting in respect whereof debt relief may be obtained.[9] Section 80(1) provides that a credit agreement is reckless if, at the time that the agreement was made, or when the amount improved in terms of the agreement is increased (other than an increase in a credit facility in terms of section 119(4))[10]

(a) the credit provider failed to conduct an assessment as required by section 81(2) irrespective of what the outcome of such an assessment might have been at the time; or

(b) the credit provider, having conducted an assessment as required by section 81(2), entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that

(i) the consumer did not generally understand or appreciate his risks, costs or obligations under the proposed credit agreement; or

(ii) entering into that (specific) credit agreement would make the consumer over-indebted.

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[6] S 78(1) of the National Credit Act excludes the application of Part D of Ch 4 from a credit agreement in respect of which the consumer is a juristic person. In terms of s 79 of the Act a consumer is over-indebted if the preponderance of available information at the time that a determination is made indicates that the consumer is or will be unable to satisfy in a timely manner all the obligations under all credit agreements to which the consumer is a party, having regard to the consumer's financial means, prospects and obligations and probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party as indicated by the consumer's history of debt repayment.

[7] These agreements include credit facilities and various types of credit transactions (including mortgage agreements) as well as suretyships entered into by natural persons in respect of credit agreements to which the Act applies. See s 8 of the Act read with ss 1 and 4 regarding the scope of application of the Act. See also Otto and Otto (n 29) 19-35 and PN Stoop, 'Kritiese evaluasie van die toepassingsveld van die 'National Credit Act'', (2008) De Jure 352.

[8] S 78(2) of the NCA. The aforesaid exclusions are subject to the proviso that any credit extended in terms of a school or student loan, an emergency loan or a public interest credit agreement is *inter alia* reported to the National Credit Register. For the reasons or probable reasons for these exclusions, see Renke LLD thesis 415-416. For the definitions of the various types of credit agreements mentioned in s 78(2), see s 1 of the NCA.

[9] Arguably a fourth type of reckless credit is envisaged by s 88(4) where a consumer who is subject to a debt re-arrangement is granted further credit while such re-arrangement still subsists.

[10] S119(4) deals with the automatic annual increase of the credit limit of a credit facility that a consumer may request at the time of application for the credit facility.

This first type of reckless credit is *per se* reckless as the credit provider's failure to conduct a pre-agreement assessment before extending credit to the consumer is inexcusable.[11] The second type of reckless credit is regarded as reckless because, even though the credit provider conducted a pre-agreement assessment, it disregarded the fact that the preponderance of available information indicated that the consumer was generally ignorant regarding the risks, costs and obligations under the credit agreement. The third type of reckless credit refers to the situation where despite the fact that a pre-agreement assessment was done which indicated that the granting of credit under the specific credit agreement would be the factor that would cause the consumer to become over-indebted, the credit provider disregarded such information and nevertheless extended credit to the consumer. The recklessness as envisaged by section 80 must have existed at the time when the credit was extended – therefore the appropriate time period with regard to which an assessment must be made of whether credit was granted recklessly, is the time of conclusion of the specific credit agreement.[12]

2.2 Peremptory pre-agreement assessment

The Act takes a pro-active approach to prevent reckless credit granting: it prohibits reckless granting[13] and imposes a peremptory pre-agreement assessment obligation[14]. With regard to the pre-agreement assessment obligation, section 81(2)(a) prohibits a credit provider from entering into a credit agreement without first taking reasonable steps to assess the proposed consumer's general understanding and appreciation of the risks and costs of the proposed credit, of his rights and obligations under a credit agreement as well as his debt repayment history as a consumer under credit agreements and his existing financial means, prospects and obligations.[15] In addition, if the consumer applies for credit for a commercial purpose, it

[11] The financial position of the consumer is irrelevant to this type of reckless credit.

[12] S 80(2) provides that when a determination is to be made whether a credit agreement is reckless or not, the person making the determination must apply the criteria for reckless credit as contained in s 80(1) as they existed at the time the agreement was made and without regard for the ability of the consumer to meet the obligations under the agreement or understand or appreciate the risks, costs and obligations under the proposed credit agreement at the time that the determination is being made. This means that if the consumer has since entering a reckless credit agreement become able to afford the credit or educated on his risks, costs and obligations under the agreement, it does not negate the fact that the credit, at the time of conclusion of the agreement, was extended recklessly. Thus granting of reckless credit cannot be remedied or ratified *ex post* the conclusion of the agreement.

[13] S81(3).

[14] S81(2).

[15] S 78(3) provides that ''financial means, prospects and obligations', with respect to a consumer or prospective consumer, includes

must be assessed whether there is a reasonable basis to conclude that such commercial purpose may prove to be successful.[16]

Consumers are also obliged to co-operate in the prevention of reckless credit: section 81(1) provides that when applying for credit, and while that application is being considered by a credit provider, the prospective consumer must fully and truthfully answer any requests for information made by the credit provider as part of the assessment.

2.3 Defence against reckless credit

Some reprieve is afforded to credit providers if consumers thwart their efforts to do a proper pre-agreement assessment: it is a complete defence to an allegation of reckless credit if the credit provider establishes that the consumer failed to answer fully and truthfully any such request for information made by the credit provider and if a court or the National Consumer Tribunal determines that the consumer's failure to do so materially affected the ability of the credit provider to make a proper assessment.[17] This complete defence against reckless credit is only available to a credit provider when both the aforementioned requirements are met provided that the credit provider indeed took reasonable steps to conduct the assessment in accordance with the matters that should be considered for purposes of section 81(2).[18]

(a) income, or any right to receive income, regardless of the source, frequency or regularity of that income, other than income that the consumer or prospective consumer receives, has a right to receive, or holds in trust for another person;

(b) the financial means, prospects and obligations of any other adult person within the consumer's immediate family or household, to the extent that the consumer, or prospective consumer, and that other person customarily -

(i) share their respective financial means; and

(ii) mutually bear their respective financial obligations; and

(c) if the consumer has or had a commercial purpose for applying for or entering into a particular credit agreement, the reasonably estimated future revenue flow from that business purpose'.

[16] S 81(2)(b). See further *Desert Star Trading 145 and Another v No 11 Flamboyant Edleen CC* [2010] ZASCA 148 pars 14 and 15.

[17] S 81(4). For a detailed discussion of this defence see C Van Heerden and A Boraine, 'The money or the box: perspectives on reckless credit in terms of the National Credit Act 34 of 2005', (2011) De Jure 396-397 and 400; M Kelly-Louw, 'A credit provider's complete defence against a consumer's allegation of reckless lending', (2014) 26 SA Merc LJ 24 ff. See further *Horwood v Firstrand Bank Ltd* [2011] ZAGPJHC 121 (21 September 2011), where the court indicated (par 6) that as s 81(4) contains a requirement of materiality, it is accordingly not every failure by a consumer to fully and truthfully answer the credit provider's request as part of the prescribed assessment that entitles the credit provider to this complete defence.

[18] Thus, if a consumer fails to answer fully and truthfully when a s 81 assessment is conducted but the aspects about which the consumer is not truthful does not materially affect the credit provider's ability to make an assessment, the complete defence against reckless credit is not available to the credit provider. In *Horwood v Firstrand Bank* (n 40) par 7 the court indicated that where a credit provider has taken the required 'reasonable steps to assess' the relevant matters referred to in s 81(2), the credit agreement is not a reckless one in terms of s 80(1), whether or not the assessment was tainted by a

2.4 Sanctions and powers of Court and Tribunal

The sanctions imposed upon a credit provider for reckless credit granting and the debt relief provided for by the Act serve a preventative purpose and are not merely remedial in nature. As indicated, reckless credit constitutes prohibited conduct in terms of the NCA with the result that the Tribunal is empowered to impose an administrative fine upon a credit provider who has granted credit recklessly.[19] This fine may not exceed the greater of 10 per cent of the credit provider's annual turnover during the preceding financial year or R1 million.[20] It is also a condition of the registration (licensing) as credit provider that such credit provider will not extend reckless credit and thus, in addition to an administrative fine, a credit provider may also be at risk of having its registration cancelled if it engages in reckless credit granting.[21] Reckless credit granting thus not only puts the reputation and financial welfare of credit providers at risk but may also compromise their continued ability to conduct their business.

The far-reaching debt relief measures contained in section 83 of the Act also serves to incentivize responsible lending whilst also remedying the ill effects of reckless credit granting. Section 83(1) provides that despite any provision of law or agreement to the contrary, in any court proceedings in which a credit agreement is being considered, the court may declare that the credit agreement is reckless, as determined in accordance with Part D of Chapter 4.[22] This power has now also been extended to the National Consumer Tribunal[23]

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consumer's incomplete or untruthful answers. The court further remarked that the complete defence provided for in s 81(4) is a defence which may be raised in addition to one that the credit provider's assessment obligations under s 81 have been met. In *Absa Bank Ltd v COE Family Trust and Others* 2012 (3) SA 184 (WCC) at 189 the court indicated that s 81(4) needs to be read with s 81(2) with the effect that, if an assessment as contemplated by s 81(2) was not undertaken in the first place, then s 81(4) is of no relevance. It should thus be noted that the mere fact that an assessment was undertaken is not sufficient as prerequisite for the credit provider being able to raise a defence in terms of s 81(4). It is only where such an assessment meets the requirements of s 81(2) that a credit provider can thereafter competently invoke the provisions of s 81(4).

[19] S 151. In 2013 African Bank was found to have contravened the National Credit Act by extending credit recklessly and faced a hefty fine of R300 million which was subsequently settled by payment of an agreed amount of R20 million–Press releases, 'Media statement on African Bank Limited', available at www.ncr.org.za, 'accessed on 1 September 2014'.

[20] S 151(2). See further s 151(3) for the factors to be taken into account in determining an administrative fine and s 151(4) read with reg 16(1) of the Regulations made in terms of the National Credit Act, 2005 (Government Notice R 489 in *Government Gazette* 28864 of 31 May 2006–hence, the National Credit Regulations, regarding the determination of the credit provider's annual turnover.

[21] S 48 .

[22] S81(3) has been amended by the National Credit Amendment Act 19 of 2014 to extend the powers mentioned in that section to the Tribunal.

[23] Established by s 26 of the NCA.

by virtue of the National Credit Amendment Act.[24] As no allegation of reckless credit is required for the operation of section 83 the court and Tribunal may *suo motu* raise the issue of reckless credit in proceedings before it in which a credit agreement is being considered.[25]

Section 83 further provides for certain debt relief orders that the court may make in respect of reckless credit.[26] Since the coming into operation of the National Credit Amendment Act the Tribunal may now also make these orders.[27] If a court or the Tribunal declares that a credit agreement is reckless in terms of section 80(1)(a) (type one reckless credit - no prior credit assessment) or 80(1)(b)(i) (type two reckless credit - the consumer did not generally understand the risks, costs or obligations under the credit agreement), the court or Tribunal has the discretion to make an order setting aside all or part of the consumer's rights and obligations under that credit agreement, as the court determines just and reasonable in the circumstances.[28] Alternatively,[29] it may suspend the force and effect of that credit agreement.[30] In respect of the third type of reckless credit which causes the consumer to become over-indebted (as described in section 80(1)(b)(ii)), once the court or Tribunal has declared the agreement reckless it must further consider whether the consumer is over-indebted at the time of those court or Tribunal proceedings.[31] If the consumer is still over-indebted at that time, it may make an order suspending the force and effect of that credit agreement until a date determined by it when making the order of suspension and it may further restructure the consumer's obligations under any other credit agreements.[32]

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[24] Act 19 of 2014.

[25] C Van Heerden, 'Over-indebtedness and reckless credit' in JW Scholtz (ed), Guide to the National Credit Act (LexisNexis) 2008-11-9 *et seq* par 11.4.3–hence, 'Scholtz Commentary'.

[26] For a detailed discussion of the powers of the court with regard to reckless credit, see Van Heerden in Scholtz Commentary par 11.4.5; A Boraine and C Van Heerden, 'Some observations regarding reckless credit in terms of the National Credit Act 34 of 2005', (2010) (73) THRHR 651-654; Van Heerden and Boraine 400-410.

[27] As per the amended s83 .

[28] S 83(2)(a).

[29] The conjunctive 'or' is used between s 83(2)(a) and (b).

[30] S 83(2)(b). For the effect of suspension of a credit agreement, see s 84 NCA.

[31] S 83(3)(a).

[32] S 83(3)(b). The restructuring is done in terms of s 87 which provides that the Magistrate's Court may re-arrange a consumer's obligations under a credit agreement and refers back to s 86(7)(c)(ii) which provides that such obligations may be re-arranged by extending the period of the agreement and reducing the amount of each payment due accordingly; postponing during a specified period the dates on which payments are due under the agreement; extending the period of the agreement and postponing during a specified period the dates on which payments are due under the agreement; or recalculating the consumer's obligations because of contraventions of Part A or B of Ch 5, or Part A of Ch 6. See further Van Heerden in Scholtz Commentary 11-34 and 11-35.

3 The evolution of the peremptory pre-agreement assessment requirement

The section 81 pre-agreement assessment as required by the National Credit Act is pivotal in preventing credit being granted recklessly and causing the consumer to become over-indebted. From the matters that the credit provider is required to have regard to when conducting the section 81 assessment it is clear that the section envisages a comprehensive assessment which not only relates to affordability but also has regard to the consumer's ability to understand the consequences of obtaining credit and his credit repayment history.[33] The National Credit Act initially did not contain any provisions detailing exactly how the assessment must be done and apart from obliging the credit provider to have regard to the very broad considerations indicated in section 81 during the pre-agreement assessment and imposing a duty on the consumer to answer truthfully during such assessment, no standard format for the assessment was prescribed.

Section 82(1) of the Act originally provided that a credit provider may determine for itself the evaluative mechanisms or models and procedures to be used in meeting its assessment obligations under section 81, provided that any such mechanism, model or procedure results in a fair and objective assessment. This provision had to be read with section 61(5) which provides that a credit provider may determine for itself any scoring or other evaluative mechanism or model to be used in managing, underwriting and pricing credit risk, provided that any such mechanism or model is not founded or structured upon a statistical or other analysis in which the basis of risk categorisation, differentiation or assessment is a ground of unfair discrimination prohibited in section 9(3) of the Constitution.[34] Section 82(1) was subject to section 82(2)(*a*) which provided that the National Credit Regulator could pre-approve the evaluative mechanisms, models and procedures to be used in terms of section 81 in respect of proposed developmental credit agreements. Section 82(2)(b) further provided that the National Credit Regulator could also publish guidelines proposing evaluative mechanisms, models and procedures, to be used in terms of

[33] Van Heerden and Boraine 397.

[34] S 9(3) of the Constitution of the Republic of South Africa, 1996 provides that the State may not unfairly discriminate directly or indirectly against anyone on one or more grounds, including race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, age ,disability, religion, conscience, belief, culture, language and birth.

section 81, applicable to other credit agreements. A guideline published by the Regulator would, however, not be binding on a credit provider.[35]

It was also envisaged that the National Consumer Tribunal would play a role in ensuring that credit providers comply with their assessment obligations. In this regard it was provided that if a credit provider repeatedly failed to meet its obligations under section 81 or customarily used evaluative mechanisms, models or procedures that do not result in a fair and objective assessment, the Regulator could apply to the Tribunal for an order in terms of section 82(4). If the Tribunal found the credit provider guilty, it could require that credit provider to apply any guidelines published by the Regulator in terms of section 82(2)(b) or any alternative guidelines consistent with prevalent industry practice, as determined by the Tribunal.[36]

Given that in the period between 1 June 2007, when the Act came into full effective operation and the first quarter of 2013, no guidelines for the pre-assessment in terms of section 81 were published by the National Credit Regulator, with the result that no matters relating to non-compliant assessment models served before the Tribunal and very few cases were reported relating to reckless credit granting, it is clear that credit providers to a large extent had a *carte blanche* in how they structured and conducted their section 81 assessments. It is thus submitted that for the first couple of years that the Act was in operation, and significantly during the global financial recess which started in 2008, the ability of the pre-agreement assessment as a measure to prevent reckless credit granting was stifled by the lack of guidelines or a more binding legal framework within which it had to be administered.

Due thereto that the Act did not lay down specific requirements other than the abovementioned broad aspects which had to be considered during the section 81 assessment, the courts had to assist in providing some guidance on when a proper assessment for purposes of section 81 could be said to have been conducted. In *Horwood v Firstrand Bank Ltd*[37] it was held that whether or not a credit grantor has taken the required reasonable steps to meet its assessment obligations is in the light of the wording of section 81(2) and 82(1) to be determined objectively on the facts and circumstances of any given case. In *SA Taxi Securitisation (Pty) Ltd v Mbatha*[38] the court, however, remarked that while one purpose of the National Credit Act is to discourage reckless credit, the Act is also

[35] S 82(3), subject to s 82(2)(*a*) and 82(4).

[36] S 82(4)(a) and (b).

[37] *Horwood v Firstrand Bank* par 5.

[38] 2011 (1) SA 310 (GSJ).

designed to facilitate access to credit by borrowers who were previously denied such access. Consequently, an over-critical armchair approach by the court towards credit providers when evaluating reckless credit, or the imposition of excessive penalties upon lenders who have recklessly allowed credit, would significantly chill the availability of credit especially to the less affluent members of our society.[39] In *Absa Bank v COE Family Trust and Others*[40] it was submitted on behalf of the credit provider that a particular clause in a mortgage loan agreement indicated that the defendants understood the risks and costs and the rights and obligations under the agreement.[41] It was alleged that this agreement covered all the requirements for the prescribed assessment and further that it was not open to the defendants to raise a defence of reckless credit because if it was established in terms of section 81(4) that the consumer failed to fully and truthfully answer requests for information made by the credit provider, this was a complete 'response' (defence) by the credit provider to the averments of the defendants.[42] The court considered the clause and indicated that there was no indication as to whether a request for information was made of any of the defendants by or on behalf of the plaintiff which request for information would have ensured that the credit process was undertaken in terms of the three pronged set of inquiries contained in section 81(2).[43] The court subsequently dismissed the application for summary judgment *inter alia* because it appeared that no assessment as contemplated by section 81(2) was conducted with the result that the issue regarding whether the consumer answered truthfully or not as envisaged by section 81(4) became of no relevance.[44]

The objective to encourage responsible lending in the South African credit market, specifically in the context of better regulation of affordability assessment (as one of the three prongs of the section 81 assessment) in order to prevent reckless credit granting, eventually gained impetus when a joint media statement was issued by the Minister of Finance and the Chairperson of the Banking Association of South Africa (BASA) in November 2012 entitled

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[39] Par 37.

[40] *Absa Bank v COE Family Trust* par 6.

[41] The particular clause reads as follows:

> 'The borrower states that
> 11.1 he undertakes his risks and costs, as well as his rights and obligations under this agreement;
> 11.2 entering into this agreement will not cause him to become over-indebted as contemplated in the National Credit Act;
> 11.3 he has fully and truthfully answered all and any requests for information made of him by or on behalf of the bank leading up to the conclusion of this agreement;
> 11.4 the bank has given the borrower a pre-agreement statement and the quotation.'

[42] Par 7.

[43] Par 11.

[44] Par 12.

'Ensuring Responsible Market Conduct for Bank Lending' as a result of an agreement that was reached at a meeting on 19 October 2012 that BASA and its member banks would *inter alia* review their approach to the assessment of affordability.[45] It was further agreed that BASA, the National Credit Regulator and the National Treasury would formulate a standard to measure affordability which could then be incorporated into regulations as minimum standards.[46] Following this, the National Credit Regulator issued a public notice[47] in May 2013 in which certain draft affordability guidelines[48] (not regulations as per the aforementioned Joint Statement) were proposed, namely that

(a) credit applicants prove their claimed discretionary income when it is above the norm for a person with their gross income and that such norms be determined as a percentage of gross income bands;

(b) credit providers consider all the credit applicant's income, expenses and debt repayments when doing an affordability assessment;

(c) credit providers refrain from lending to the maximum of the consumer's discretionary income and leave a margin of at least 25 percent of their discretionary income for adverse changes in the economy or the consumer's circumstances;

(d) credit providers use the credit applicant's current information as stored on one or more credit bureaux;

(e) credit providers process applications for credit within seven days from assessing an applicant's credit information as stored on credit bureaux; and

(f) credit providers share credit application information on credit bureaux to allow for better affordability assessments to be made by other credit providers and to reduce credit application fraud.

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[45] Joint Statement 'Ensuring Responsible Market Conduct for Bank Lending' (November 2012), available at http://www.treasury.gov.za/comm_media/press/2012/2012110101.pdf, 'accessed on 24 July 2014'–hence, the 'Joint Statement'.

[46] Joint Statement 3. The said agreements and commitments relate only to the member banks of BASA but other credit providers such as non-bank micro-lenders and retailers, were also encouraged to conform to the good practices committed to by the Banks.

[47] Comments in the proposed guidelines were invited by 14 June 2013–see http://www.ncr.org.za/press_release/Public%20Notice%20.pdf, 'accessed on 5 August 2014'. See also the 'Credit Provider's Code of Conduct to Combat Over-indebtedness', available at http://www.ncr.org.za/pdfs/Circulars/Code%20of%20Conduct%20for%20CPs.pdf.

[48] Hence, the 'May 2013 Draft Guidelines'.

The National Credit Regulator followed up on the May 2013 Draft Guidelines in a circular during September 2013 entitled 'Affordability Assessment Guidelines'.[49] The September 2013 Draft Guidelines were significantly more comprehensive than those which appeared in May 2013[50] and would apply to all credit providers and to all credit agreements to which the Act applies but not to a credit agreement in terms whereof the prospective consumer or consumer is a juristic person as defined in the Act.[51] These Guidelines would also (in line with section 78(2) of the Act) not apply to the following credit agreements: a developmental credit agreement; a school loan or a student loan; a public interest credit agreement; a pawn transaction; an incidental credit agreement; an emergency loan; a temporary increase in the credit limit under a credit facility; a unilateral credit limit increase under a credit facility in terms of section 119(1), 119(4) and 119(5) of the Act and a pre-existing Credit Agreement in terms of Schedule 3 item 4(2) of the Act. It also provided that where indicated, parts of the Guidelines would have limited application to secured credit agreements.[52]

A number of significant definitions not contained in the National Credit Act was introduced to facilitate the application of the September 2013 Draft Guidelines.[53] 'Joint prospective consumers or joint consumers' would mean the prospective consumers or consumers that are co-principal debtors and jointly and severally liable with regard to the same credit agreement and applies jointly for the credit agreement. Prospective consumers or consumers married in community of property that apply separately for a credit agreement and sureties were specifically excluded from the aforesaid definition. 'Discretionary income' was defined to mean gross income less statutory deductions (such as income tax and UIF) less necessary expenses (at a minimum as defined in the Guidelines) less all other committed payment obligations *including* such obligations as may appear in the credit applicant's credit records as held by any credit bureau.[54] 'Allocatable income' meant gross income less statutory deductions (such as income tax and UIF) less necessary expenses (at

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[49] Or the 'September 2013 Draft Guidelines', available at www.ncr.org.za.

[50] It was provided that the National Credit Regulator would notify credit providers of any amendment to the Guidelines as well as the implementation periods by publishing them on its website and by sending them via email, facsimile or prepaid registered post to the contact details provided by credit providers to the Regulator.

[51] September 2013 Draft Guidelines 3. Given that juristic person consumers are not entitled to the remedies relating to reckless credit it follows that the Guidelines would also not apply to them.

[52] September 2013 Draft Guidelines 1.

[53] September 2013 Draft Guidelines 2.

[54] September 2013 Draft Guidelines 2.

a minimum as defined in the Guidelines) whilst 'allocatable income buffer' was defined to mean a percentage of the allocatable income which credit providers are required to allow for changes in the consumer's financial circumstances. 'Necessary expenses' referred to the prospective consumer's minimum living expenses in regard to food, transport and accommodation as determined in accordance with paragraph 5.2 of the Guidelines as discussed hereinafter. 'Unsecured term credit agreement' meant a credit transaction (excluding a pawn transaction; discount transaction, incidental credit agreement, instalment agreement, mortgage agreement, secured loan and lease) in respect of which the deferred amount is not secured by a pledge of movable property, cession of a thing of value or rights, mortgage over immovable property, suretyship or other personal security or a right in property other than credit insurance. 'Secured credit agreement' was defined as 'a credit agreement in respect of which the deferred amount is secured by a pledge of immovable property, cession of a thing of value or rights, mortgage over immovable property, suretyship or other personal security or a right in property other than credit insurance'.

The September 2013 Draft Guidelines stated that the assessment envisaged by section 81 is more comprehensive than (merely) assessing the probability of default by a consumer[55] and that the Guidelines were intended to establish 'calculation norms' for credit providers to take the reasonable steps in assessing the prospective consumer's existing financial means, prospects and obligations as contemplated in section 81(2)(a)(iii) of the Act.[56] Regarding calculation of the consumer's means and prospects when concluding a section 81 pre-agreement assessment the September 2013 Draft Guidelines[57] require credit providers to take reasonable steps to assess the prospective consumer's allocatable income as well as his discretionary income to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments.[58] Credit providers are further required[59] to take reasonable steps to validate income by referring to the prospective consumer's payslips and/or bank statements and/or by obtaining other credible information either written or electromagnetically recorded, of the prospective consumer's income. Where the prospective consumer's monthly income shows variance, the average income over the period of not less than three months preceding must be utilised.[60]

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[55] September 2013 Draft Guidelines 3.

[56] ibid.

[57] 4.

[58] This also applies to joint prospective consumers or joint consumers.

[59] September 2013 Draft Guidelines 4.

[60] This also applies to joint consumers or joint prospective consumers.

With regard to the calculation of existing financial obligations[61] a Table 1[62] is included in the September 2013 Draft Guidelines and reflects the minimum living expense norms (necessary expenses), broken down by annual gross income, that may be accepted by credit providers, absent evidence to the contrary, when credit providers calculate the existing financial obligations of prospective consumers in terms of section 81(2)(a)(iii) of the Act.[63] It was further provided that where prospective consumers claim to have transport, accommodation or food expenses which are cumulatively *less* than that set out in Table 1, they should be required by the credit provider to evidence their claimed lower necessary expenses by means of appropriate documentation.[64] In respect of unsecured term credit agreements, credit providers are required to ensure that the prospective consumer discloses necessary expenses equal or exceeding those reflected in Table 1, alternatively the credit provider must obtain credible written evidence that the prospective consumer's disclosed necessary expenses are below those set out in Table 1.[65] The guidelines stipulated that any

[61] September 2013 Draft Guidelines 4 and 5. The aforementioned principles with regard to existing financial obligations also apply to joint prospective consumers or joint consumers.

[62] **Table 1**

After tax income percentage of monthly household income to be made available as a minimum for repayment of debt

Annual Gross Income		**Annual Fixed Factor (Food, Transport, Accommodation)**	**Annual Fixed Factor + % of Income above Band Min**
Min	Max		
R0	R14,400	0	100%
R14,400.01	R75,000	R14,400	6.75%
R75,000.01	R300,000	R18,500	9%
R300,000.01	R600,000	R40,500	8.2%
R600,000.01	High	R65,100	6.75%

[63] Par 5.2.1.of the September 2013 Draft Guidelines. The following example was provided to illustrate how Table 1 operates: should the prospective consumer have an annual gross income of R24 000, the credit provider may not accept annual necessary expenses of less than R14 400 plus R648 (being 6.75% of R9 600) unless same is evidenced as required in the September 2013 Draft Guidelines. It was further provided that Table 1 will be periodically reviewed by the National Credit Regulator.

[64] Par 5.2.2 of the September 2013 Draft Guidelines.

[65] Par 5.2.3 of the September 2013 Draft Guidelines. The Guidelines mention that examples of credible evidence would include but would not be limited to payments reflected on bank statements, lease agreements, home loan statements, unencumbered deeds of title, personal credit records, vehicle leases or finance agreements , letters from a tribal authority or other similar documents.

credit provider that enters into an unsecured term credit agreement with a consumer where such consumer's necessary expenses are below that set out in Table 1, without credible evidence in support of same, may be referred by the National Credit Regulator to the National Consumer Tribunal on the basis that they have lent recklessly as that concept is envisaged in section 80(1)(b)(ii) of the Act. [66]

In respect of the regard that should be had to the consumer's debt repayment history as consumer under credit agreements (which will usually be reflected on the credit record of the consumer as held by one or more Credit Bureaux) it was provided that credit providers must take into consideration all debt, including monthly debt repayment obligations in terms of credit agreements, as reflected on the prospective consumer's credit profile held by a credit bureau when calculating the prospective consumer's allocatable income and discretionary income and in making an affordability assessment.[67] This affordability assessment calculation must include the minimum payments due under credit facilities.[68] In addition credit providers must ensure that these requirements are performed during the seven business days immediately prior to the initial granting of credit or to the increasing of a credit limit.[69]

Guidelines on 'Avoiding double counting in calculating allocatable income' provided that where credit agreements are entered into on a substitutionary basis, in order to pay off one or more existing credit agreements, credit providers should record that the credit being applied for is to replace other existing credit agreement/s and take reasonable steps to ensure that such credit is properly used for such purpose.[70] Guidelines on Credit Literacy were also laid down as part of the September 2013 Draft Guidelines,[71] namely that credit providers must take reasonable steps to display such credit literacy posters and make available such credit literacy materials to their clients and prospective consumers, as the National Credit Regulator may issue from time to time[72] and that credit providers must perform such credit literacy surveys as the National Credit Regulator may require from time to time.[73]

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[66] Par 5.2.4 of the September 2013 Draft Guidelines. All other credit agreements and more specifically 'Secured Credit Agreements' were excluded from this provision.

[67] Par 5 and 6 of the September 2013 Draft Guidelines. The aforementioned principles with regard to debt repayment history under credit agreements also apply to joint prospective consumers or joint consumers.

[68] Par 6.2 of the September 2013 Draft Guidelines.

[69] Par 6.3 of the September 2013 Draft Guidelines.

[70] Par 7.1 of the September 2013 Draft Guidelines.

[71] Par 8.

[72] Par 8.1 of the September 2013 Draft Guidelines.

[73] Par 8.2 of the September 2013 Draft Guidelines.

Finally it was laid down that the abovementioned September 2013 Draft Guidelines should be read with the Credit Provider's Code of Conduct to Combat Over-indebtedness, also dated September 2013.[74]

Various problems manifested themselves during the initial years that the National Credit Act was in operation as a result whereof, after seeing a formidable number of drafts, the NCA Amendment Act was eventually approved a couple of months after the September 2013 Draft Guidelines. The NCA Amendment Act (which has now been put into operation on 13 March 2015)[75]*inter alia* introduces significant amendments to the assessment mechanisms and procedures set out in section 82. In brief it introduces an amendment to section 48 of the National Credit Act so that it now provides for the Minister to prescribe criteria and measures to determine the outcome (*sic*) of affordability assessments.[76] The Minister must, on recommendation of the National Credit Regulator, make affordability assessment regulations.[77] Section 82(3) and (4) of the Act is deleted and section 82(1) and (2) substituted to provide that a credit provider may determine for itself the evaluative mechanisms or models and procedures to be used in meeting its assessment obligations under section 81, provided that any such mechanism, model or procedure results in a fair and objective assessment which *must not be inconsistent with the affordability assessment regulations*[78] made by the Minister.[79]

The effect of the aforesaid amendments is that the evaluative models used by credit providers will have to be aligned with the affordability assessment regulations issued by the Minister. As indicated below, upon being issued by way of regulations, these affordability assessment 'guidelines' are now binding on credit providers, contrary to the previous position under section 82(3) that guidelines published by the National Credit Regulator were not binding. The deletion of section 82(4) also means that the Tribunal cannot hear matters where it is alleged that the credit provider failed to meet its assessment obligations under section 81 or used evaluative methods that did not result in fair and objective assessment.

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[74] Par 9.1 of the September 2013 Draft Guidelines.

[75] As per GG 38557 of 13 March 2015.

[76] S 15(c). Obviously the Minister cannot determine the outcome of these assessments but merely how the assessments must be conducted.

[77] S 24 of the NCA Amendment Act .

[78] Authors' emphasis.

[79] S 24 of the NCA Amendment Act. See also s 15(b) of the NCA Amendment Act which provides for the amendment of the current s 48 to the effect that with regard to registration of credit providers the compliance by a credit provider with a prescribed code of conduct as well as the affordability assessment regulations made by the Minister on the recommendation of the National Credit Regulator, may be considered.

This is however counterbalanced by the procedure created for consumers to complain to the Tribunal about the outcome of affordability assessments as discussed below.

The affordability assessment regulations as discussed below now provide a benchmark against which a credit provider's compliance with its pre-agreement assessment duty in terms of section 81 will be measured. As a minimum, they lay down certain standard requirements which such assessments will have to meet in order to pass the obligation of the credit provider to refrain from reckless credit granting.

After the publication of the National Credit Amendment Act but prior to the Amendment Act being put into operation, a comprehensive set of draft regulations on various matters including regulations on affordability assessment, were published in August 2014 for public comment.[80] Chapter 1 of the aforesaid regulations contains the following amplified and expanded set of definitions: 'Allocatable income' is more comprehensively defined than in the September 2013 Draft Guidelines and means gross income less statutory deductions such as income tax, unemployment insurance and maintenance payments, less necessary expenses (as defined in the regulations). A definition of 'Credit Cost Multiple', which did not appear in the September 2013 Draft Guidelines, was also inserted and refers to the ratio of the total cost of credit to the advanced principal debt, that is, the total cost of credit divided by the advanced principal debt expressed as a number to two decimal places. 'Credit Profile' means the consumer's payment profile, including adverse information held by a credit bureau. 'Payment profile' means a payment profile as defined in regulation 17(5), namely that it refers to a consumer's repayment history in respect of a particular transaction.

The definition of 'Discretionary income' was also amplified to mean gross income less statutory deductions such as income tax, unemployment insurance fund, maintenance payments less necessary expenses (at a minimum defined in the regulations); less all other committed payment obligations including such as may appear from the credit applicant's credit records as held by any credit bureau which income is the amount available to fund the proposed credit instalment. 'Gross income' means all income earned without deductions from whatever source. 'Joint consumers' means consumers that are co-principal debtors who are jointly and severally liable with regard to the same credit agreement and apply jointly for the credit agreement, excluding the surety or a credit guarantor under a credit guarantee. The exclusion of consumers married in community of property who apply separately for credit which appeared in the September 2013 Draft Guidelines was omitted

[80] Government Notice R. 597 in *Government Gazette* 37882 of 1 August 2014–hence, the '2014 Draft Regulations'.

from the aforesaid definition. 'Necessary expenses' are more comprehensively defined than in the September 2013 Draft Guidelines which only referred to expenses in regard to food, transport and accommodation, to mean the 'consumer's minimum living expenses as determined in accordance with regulation 23A(9) together with any other necessary living expenses excluding debt repayments'. The definitions regarding unsecured term credit agreements and secured term credit agreement which appeared in the September 2013 Draft Guidelines were omitted from the 2014 Draft Regulations.

In the context of affordability assessment the 2014 Draft Regulations amend the National Credit Regulations that were issued when the Act came into operation (and which did not include affordability assessment guidelines), *inter alia* by the insertion of a regulation 23A entitled 'Criteria to conduct Affordability Assessment'. The regulations apply to current, prospective and joint consumers; all credit providers and all credit agreements to which the Act applies (subject to regulation 23A(2)).[81] Similar to the September 2013 Draft Guidelines it is stated that the regulations do not apply where the consumer is a juristic person and it excludes all the credit agreements previously excluded by the September 2013 Draft Guidelines from its ambit.[82] It, however, expands on the excluded credit agreements mentioned in the September 2013 Draft Guidelines by providing that the regulations do not apply to any change to a credit agreement and/or any deferral or waiver of an amount under an existing credit agreement[83] or to Mortgage Agreements that qualify for the Finance Linked Subsidy Programs developed by the Department of Human Settlements and credit advanced for housing that falls within the threshold set from time to time.[84]

With regard to existing 'financial means and prospects' the 2014 Draft Regulations, similar to the September 2013 Guidelines, stipulate that a credit provider must take practicable steps to assess the consumer or joint consumers' allocatable income as well as their discretionary income to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments.[85] Similarly, it also provides that a credit provider is required to take steps to validate gross income by referring to recent three months consumer's pay slips; recent three months bank statements and any other similar

[81] Reg 23A(1).

[82] Reg 23A(2)(a)-(i).

[83] In accordance with s 95 of the Act–reg 23A(2)(j).

[84] Reg 23A(2)(k).

[85] Reg 23A(3).

credible information.[86] Where the consumer's monthly gross income shows material variance, the average gross income over the period of not less than three months preceding the credit application must be utilised.[87]

However, it should be noted that the 2014 Draft Regulations refer to 'practicable' steps instead of 'reasonable' steps as was indicated in the September 2013 Draft Guidelines and required by section 81 of the Act.

The 2014 Draft Regulations oblige the consumer to accurately disclose to the credit provider *all* financial obligations to enable the credit provider to conduct the affordability assessment.[88] The consumer is further obliged to disclose authentic documentation for purposes of the affordability assessment.[89] Insofar as the consumer's existing financial obligations are concerned, the credit provider is required to make a calculation of the consumer's existing financial means, prospects and obligations as envisaged in sections 78(3) and 81(2)(a)(iii) of the Act.[90] More or less similar to the September 2013 Draft Guidelines the credit provider may, however, on an exceptional basis, where justified, accept the consumer's declared necessary expenses which are lower than those set out in a revised Table 1[91] (which sets out specific information based on the consumer's monthly (and not annual) gross income bands that differ appreciably from those in the September 2013

[86] Reg 23A(4).

[87] Reg 23A(5).

[88] Reg 23A(6).The word 'must' is used.

[89] Reg 23A(7).The word 'must' is used.

[90] Reg 23A(8). This calculation must also be done for applications that relate to the extension of existing credit agreements.

[91] **(Revised) Table 1: Necessary Expense Norms**

Monthly Gross Income		**Minimum Monthly Fixed Factor**	**Monthly Fixed Factor + 0% of Income Above Band Minimum**
Minimum	Maximum		
R0.00	R800.00	R0.00	100%
R800.01	R6,250.00	R800.00	6.75%
R6,250.01	R25,000.00	R1,541.67	9.00%
R25,000.01	R50,000.00	R3,375.00	8.20%
R50,000.01	Unlimited	R5,425.00	6.75%

Draft Guidelines). However, this may only be done if a questionnaire[92] (and not merely credible written evidence as required by the September 2013 Draft Guidelines) is completed by the consumer or joint consumers.[93]

The 2014 Draft Regulations further prescribe that when conducting the affordability assessment, a credit provider must calculate the consumer's allocatable and discretionary income; take into account all debts, including monthly debt repayment obligations in terms of credit agreements as reflected on the consumer's credit profile held by a registered credit bureau; and take into account maintenance obligations arising from statutory deductions or necessary expense.[94]

With regard to the consumer's debt repayment history as a consumer under credit agreements the regulations oblige the credit provider to take such history into account as envisaged in section 81(2)(a). It must further be ensured that this requirement is performed within seven business days immediately prior to the initial granting of credit or the increasing of an existing credit limit; and within 14 business days with regards to mortgages.[95]

For purposes of avoiding double discounting in calculating the consumer's allocatable income a provision similar to that in the September 2013 Draft Guidelines is contained in the 2014 Draft Regulations.[96] In addition it is prescribed, with regard to disclosure of credit cost multiple and the total cost of credit,[97] that a credit provider must disclose to the consumer the credit cost multiple and total cost of credit in the pre-agreement statement and quotation.[98] It must be ensured that the credit cost multiple disclosures for

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[92] Annexure B to the 2014 Draft Regulations contains the 'Declaration of Consumer's necessary expense questionnaire. The questionnaire includes a declaration whereby the consumer/s completing the questionnaire is reminded that in terms of section 81(1) of the National Credit Act when applying for a credit agreement and while that credit agreement is being considered by the credit provider, the prospective consumer must fully and truthfully answer any requests for information made by the credit provider as part of the assessment and that misrepresentation of facts will be dealt with in terms of the applicable law. Part 1 of the questionnaire deals with the consumer's details. Part 2 addresses the consumer's necessary expenses and requires the consumer to indicate the relevant income band that applies to him and to set out the amount of his declared monthly expenses. Part 3 provides for the consumer to disclose in detail his expenses in respect of accommodation, transport, food, education, medical costs, water and electricity and maintenance.

[93] Reg 23A(9).

[94] Reg 23A(10).

[95] Reg 23A(11). Although not specifically stated it appears that one can safely assume the legislature meant within 14 business days immediately prior to entering into a mortgage agreement.

[96] Reg 23A(12).

[97] 'Cost of credit' is not defined in the regulations. S 101 of the NCA deals with cost of credit and sets out the various costs that may be charged in respect of a credit agreement to which the Act applies. See Renke LLD thesis (n 9) 489 ff.

[98] Reg 23A(13)(a). The total cost of credit that must be disclosed may include the principal debt, interest, initiation fee (if any), service fee aggregated to the life of a loan and credit insurance (depending upon discretion of the consumer aggregated to the life of a loan) – reg 23A(13)(d).

credit facilities must be based on one year of full utilisation up to the credit limit proposed and that the attention of the prospective consumer is drawn to the credit cost multiple and that the cost of credit, as disclosed, is understood by the consumer.[99]

The 2014 Draft Regulations also introduce a new right for the consumer regarding the outcome of an affordability assessment: a consumer who is aggrieved by the outcome of affordability assessment may at any time lodge a complaint in terms of section 134[100] or 136[101]of the National Credit Act with the credit provider for dispute resolution.[102] The credit provider is then obliged to resolve the complaint within fourteen days.[103] If the grievance is not addressed by the credit provider, the consumer can approach the National Credit Regulator.[104]

It is important to note that the 2014 Draft Regulations do not make any specific distinction between unsecured term credit agreements and secured term credit agreements for purposes of the section 81 assessment and it specifically does not contain a provision similar to the September 2013 Draft Guidelines that a credit provider who enters into an unsecured term credit agreement where the consumer's living expenses are below the prescribed limit may be charged with reckless lending.[105] However, Chapter 6 of the 2014 Draft Regulations further contains an unnumbered provision which stipulates that the regulations are binding to the extent of their application and that failure by the credit provider to comply will *inter alia* amount to prohibited conduct or reckless lending conduct and failure to comply by the consumer will *inter alia* amount to misrepresentation.

On 13 March 2015, after having received public comments on the August 2014 Draft Regulations, the final "National Credit Regulations including Affordability Assessment Regulations" were published and were put into effect together with the National Credit Amendment Act.[106] As indicated these final regulations will now constitute the minimum

[99] Reg 23A(13)(b) and (c).

[100] S 134 provides for alternative dispute resolution.

[101] S 136 provides that any person may submit a complaint regarding an alleged contravention of the Act to the National Credit Regulator in the prescribed manner and form. It further provides that the National Credit Regulator may initiate a complaint in its own name.

[102] Reg 23A(14)(a).

[103] Reg 23A(14)(b)

[104] Reg 23A(14)(c).

[105] See par 5.2.4 of the September 2013 Draft Guidelines.

[106] National Credit Regulations including Affordability Assessment Regulations published in GG No 38557 of 13 March 2015.

standards which credit providers will have to comply with from 13 March 2015 in conducting the pre-agreement assessment envisaged by section 81.[107] The definitions contained in the final Affordability Assessment Regulations differ from the 2014 Draft Regulations in the following respects:

(a) The final Affordability Assessment Regulations have omitted the definition of "allocatable income" in Chapter 1 which deals with "Interpretation and Definitions".[108]

(b) It has substituted the definition of "credit profile" in the 2014 Draft Regulations with a definition of "credit record" – apart from using the word "record" instead of profile, the content of the definitions are similar.

(c) The definition of "discretionary income" as it appeared in the 2014 Draft Regulations is similar except that it has now been amplified to make provision for the subtraction from the consumer's gross income of all other committed payment obligations "*as disclosed by a consumer*".[109]

(d) The definition of "necessary expenses" has been amplified to refer to the consumer's minimum living expenses "*including maintenance payments if applicable*" as determined in accordance with Regulation 23A (9) "*excluding monthly debt repayment obligations in terms of credit agreements as reflected on the prospective consumer's credit profile held by a credit bureaux*".[110]

(e) Whereas the 2014 Draft Regulations merely indicated that "Payment Profile" was "as defined in regulation 17(5)" the Final Regulations define "Payment Profile" in more detail, namely that it refers to "the consumer's payment history in respect of a particular transaction".

The Criteria to Conduct Affordability Assessment[111] as set out in Chapter 3 of the final Regulations are substantially similar to the August 2014 draft regulations. Its scope of

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[107] Where allegations of reckless credit are made based on a s 81-assessment which was conducted prior to 13 March 2015 the original considerations where no binding guidelines for the assessment existed, will apply.

[108] See the definition of "allocatable income" as contained in the 2014 Draft Regulations.

[109] Author's emphasis.

[110] Author's emphasis.

[111] Regulation 23A.

application has remained exactly as was set out in the 2014 Draft Regulations.[112] The following should however be noted:

(a) Regulation 23A (3) has been toned down to provide that a credit provider must take practicable steps to assess the consumer or joint consumer's discretionary income (not their allocatable as well as discretionary income as provided in the Draft Regulations) to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments.[113]

(b) Regulation 23A (4) which provides for the validation of gross income has been amplified to distinguish between consumer's who receive a salary from an employer, those that do not receive a salary from an employer and consumers that are self-employed, informally employed or who do not receive payslips. The amplified regulation 23A (4) now provides as follows:

> "A credit provider must take practicable steps to validate gross income, in relation to:
> (a) consumers that receive a salary from an employer:
> (i) latest three (3) payslips; or
> (ii) latest bank statements showing latest three (3) salary deposits;
> (b) consumers that do not receive a salary as contemplated in (a) above by requiring:
> (i) latest three (3) documented proof of income; or
> (ii) latest three (3) months bank statements;
> (c) consumers that are self-employed, informally employed or employed in a way through which they do not receive a payslip or proof of income as contemplated in (a) or (b) by requiring:
> (i) latest three (3) months bank statements; or
> (ii) latest financial statements."

(c) Where the consumer's monthly gross income shows material variance, the average gross income over the period of not less than three "pay periods" (not "months" as stipulated in the Draft Regulations) preceding the credit application must be utilized.[114]

(d) Similar to the 2014 Draft Guidelines it is provided that the consumer must accurately disclose to the credit provider all financial obligations to enable the credit provider to conduct the affordability assessment.[115]

(e) Different to the 2014 Draft Regulations it is provided that the consumer must "provide" (and not merely "disclose") authentic documentation to the credit provider to enable it to conduct the affordability assessment.[116]

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[112] Reg 23A (1) and (2).

[113] This also explains the non-inclusion of the definition of "allocatable income" in the final Regulations.

[114] Reg 23A (5).

[115] Reg 23A (6).

[116] Reg 23A (7).

(f) Whereas the 2014 Draft Regulations provided with regard to "existing financial obligations" that "[A] credit provider must make a calculation of the consumer's existing financial means, prospects and obligations as envisaged in sections 78(3) and 81(2)(a)(iii) of the Act *and this calculations must also be done for applications that relate to extension of existing agreements*",[117] the final regulation 23A (8) merely provides that "a credit provider must make a calculation of the consumer's existing financial means, prospects and obligations as envisaged in sections 78(3) and 81(2)(a)(iii) of the Act".

(g) A new sub-regulation has been inserted in the final regulations as regulation 23A (9) and provides that "[T]he credit provider *must* utilise the minimum expense norms table below, broken down by monthly gross income when calculating the existing financial obligations of consumers".

(h) A further new sub-regulation has now been included in the form of regulation 23A (10) which provides as follows:

> "(10) The methodology in the table requires for:
> (a) credit providers to ascertain gross income;
> (b) statutory deductions and minimum living expenses to be deducted to arrive at a net income, which must be allocated for payment of debt instalments; and
> (c) when existing debt obligations are taken into account, the credit provider must calculate discretionary income to enable the consumer to satisfy any new debt."

(i) Table 1 insofar as the "minimum monthly fixed factor" is concerned, has been slightly amended.[118]

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117 Author's emphasis.

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Minimum	**Maximum**	**Minimum monthly Fixed Factor**	**Monthly Fixed Factor = % of Income Above Band minimum**
R0.00	R800.00	R0.00	100%
R800.01	R6,250.00	R800.00	6.75%
R6,250.01	R25,000.00	R1,167.88	9.00%
R25,000.01	R50,000.00	R2,855.38	8.20%
R50,000.01	Unlimited	R4,905.38	6.75%

(j) Final regulation 23A (11) and (12) now addresses the aspects initially dealt with in draft Regulations 23A (9) and 23A (10) respectively. Final regulation 23A (11) provides that the credit provider may, on an exceptional basis, where justified, accept the consumer's declared "*minimum*"[119] expenses which are lower than those set out in table 1 provided the questionnaire set out in the Schedule as issued from time to time, is completed by the consumer or joint consumers.

(k) Final regulation 23A (12) is a slightly rephrased version of draft Regulation 23A (10) and provides that when conducting the affordability assessment, the credit provider is obliged to

a. calculate the consumer's discretionary income (and not the allocatable and discretionary income as previously provided);
b. take into account all monthly debt repayment obligations in terms of credit agreements as reflected on the consumer's credit profile held by a registered credit bureaux; and (the words "all debts, including monthly debt repayments" as it appeared in draft regulation 23A (10)(b) has been replaced);
c. take into account maintenance obligations and other necessary expenses (the words "maintenance obligations arising from statutory deductions or necessary expenses" as it appeared in draft regulation 23A (10(c) have been altered).

(l) Final regulation 23A (13) is nearly exactly similar to draft regulation 23A (11) and provides that a credit provider is obliged to take into account the consumer's debt repayment history as a consumer under credit agreements, as envisaged in section 81(2)(a) and must ensure that this requirement is performed within seven business days immediately prior to the initial "approval" (not the "granting" as provided in the draft regulations) of credit or the increasing of an existing credit limit and within 14 business days with regards to mortgages.[120]

(m) Final regulation 23A (14) is basically similar to draft regulation 23A (12). It is however entitled "Avoiding double counting in calculating the *Discretionary* Income" as opposed to the draft regulation which was entitled "Avoiding double counting in

[119] This word was added.

[120] Reg 23A (13)(a) and (b). The regulation does not, with regard to mortgages, explicitly state that the requirement must be performed within 14 business days immediately prior to the initial approval of credit but it is submitted that the likely inference is that those words should also be read into reg 23A (13)(b).

Allocatable Income". It specifies that where a credit agreement is entered on a substitutionary basis in order to "settle off" (not "pay off" as per the draft regulation) one or more existing credit agreement a credit provider must record that the credit being applied for is to replace other existing credit agreement(s) and take practicable steps to ensure that such credit is properly used for such purposes.

(n) Regulation 23A (15) is a completely verbatim version of draft regulation 23A (13) and provides for disclosure of the credit cost multiple[121] and the total cost of credit.

(o) Similar to draft regulation 23A (14)(a), (b) and (c), the more elaborate final regulation 23A (16) to (20) now appears under the heading "Outcome of Affordability Assessment" and also deals with the procedure to be followed by a consumer who is aggrieved by the outcome of an affordability assessment. Regulation 23A (16) is a verbatim version of draft regulation 23A (14)(a) and provides that a consumer who is aggrieved by [the] outcome of affordability assessment may at any time lodge a complaint in terms of section 134 or 136 with the credit provider for dispute resolution. Regulation 23A (17) is more elaborate than draft regulation 23A (14)(b) as it provides that the credit provider "must" (not merely "should" as per the draft regulation") resolve the complaint within 14 "business" days and adds the clarification that these days must be calculated with reference to "receiving notification of the complaint from the ombud in terms of section 134". Regulation 23A (15) is more elaborate than draft Regulation 23A (14)(c) as it states that if the grievance is not addressed by the credit provider "within the period referred to in sub-regulation 10A (15)", the consumer can approach the National Credit Regulator. The reference to "sub-regulation 10A (15)" is clearly wrong and should be to regulation 23A (15) thus requiring amendment. Regulation 23A (19) is new and had no counterpart in the draft regulations. It obliges the National Credit Provider to resolve a complaint under Regulation 23A (18) with seven business days presumably from the date of filing of the complaint. Regulation 23A (20) is also new and provides that if the National Credit Regulator issues a notice of non-referral in response to a complaint, the consumer may refer the matter directly to the National Consumer Tribunal.

(p) The final regulations, like the draft regulations, which contained an elaborate provision relating to the "Binding nature of the Regulations" in Chapter 6 now include a more toned down version of the consequences of "Non-compliance in terms of these Regulations". It now merely states that the Regulations are binding to the

[121] As defined in reg 1.

extent of their application and that non-adherence with the Regulations will be dealt with in terms of the remedies and procedures under the National Credit Act.

(q) The final regulations have also incorporated the living expenses questionnaire referred to in Regulation 23A (11) in Schedule 2. This questionnaire is similar to the questionnaire in the draft regulations.

4 Other matters that may influence affordability assessment

Finally, in the context of the pre-agreement assessment as required by the National Credit Act, and the regard it requires to be had to the consumer's debt repayment history, it should be noted that section 69 of the Act provides for the establishment of a National Register of Credit Agreements to which credit providers must report details regarding the consumer and the specific credit agreement upon entering into or amending a credit agreement.[122] The credit provider must also report the particulars of the termination and satisfaction[123] of any agreement so reported as well as instances where a transfer of rights has occurred.[124] In the alternative to reporting to the National Credit Register credit providers are obliged to report such information to a credit bureau registered in terms of the Act.[125] Currently a National Register as envisaged in section 69 has not yet been established and credit providers thus report the necessary information on credit agreements to a number of credit bureaux. Not only positive information but also adverse information such as the granting of judgments in respect of credit agreements is reported to these credit bureaux. Unfortunately not all credit providers comply with this reporting obligation with the result that the consumer's profile with the credit bureaux might not necessarily be hundred per cent accurate.

Note should also be taken of the 'Removal of Adverse Consumer Credit Information and Information relating to Paid Up Judgments Regulations[126] which came into effect on 1 April 2014. In terms thereof a registered credit bureau is obliged to remove adverse credit

[122] S 69(2)(a) to (e) sets out the information that must be reported.

[123] S 69(3).

[124] S 69(4).

[125] S 69 read with s 43.

[126] Published in *Government Gazette* 37386 of 26 February 2014–hence, the 'Credit Amnesty Regulations'. It is to be noted that the Department of Trade and Industry has also proposed that certain amendments be made to the Magistrates' Courts Act 32 of 1944 to effectively deal with the rescission or abandonment of judgments as a mechanism for granting credit information amnesty. See further Working document, 'Magistrates' Court Amendment Bill', (21 February 2013), available at http://www.rebels.co.za, 'accessed on 5 September 2013'.

information[127] as reflected on a consumer's records held by it as at the effective date of the regulations and information relating to paid up judgments[128] on an ongoing basis.[129] Such adverse consumer credit information and information relating to paid up judgments must be removed within a period of two months from the effective date of the aforesaid Credit Amnesty Regulations.[130] Regulation 2(h) further provides that during the two month period contemplated in regulation 2(b), a registered credit bureau must ensure that the adverse consumer credit information and information relating to paid up judgments that are required to be removed, are not displayed or provided to credit providers, or any person requesting such information. After the two month period mentioned in regulation 2(b), a registered credit provider is obliged to remove information relating to paid up judgments within seven days after receiving proof of such payment.[131] Credit providers are also tasked by regulation 3 to submit information regarding paid up judgments and adverse consumer credit information to the credit bureaux. It is *inter alia* expressly stated that a credit provider must not use adverse consumer credit information and information relating to paid up judgments that have been removed in terms of these regulations for any reason, *including credit scoring and assessment*.

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[127] Reg 1 of the Credit Amnesty Regulations defines 'adverse consumer credit information' to mean

> '(a) adverse classifications of consumer behaviour are subjective classifications of consumer behaviour and include classifications such as 'delinquent', 'default', 'slow paying', 'absconded' or 'not contactable';
>
> (b) adverse classifications of enforcement action, which are classifications related to enforcement action taken by the credit provider, including classifications such as 'handed over for collection or recovery', 'legal action' or 'write-off';
>
> (c) details and results of disputes lodged by consumers irrespective of the outcome of such disputes;
>
> (d) adverse consumer credit information contained in the payment profile represented by means of any mark, symbol, sign or in any manner or form.'

The concept 'adverse consumer credit information' as per the Credit Amnesty Regulations is thus broader than that contained in regulation 17(3) and (4) of the National Credit Regulations (n 51).

[128] Reg 1 of the Credit Amnesty Regulations defines 'paid up judgments' to mean 'civil court judgment debts, including default judgments, where the consumer has settled the capital amount under the judgment(s)'.

[129] Reg 2(a) of the Credit Amnesty Regulations.

[130] Reg 2(b) of the Credit Amnesty Regulations.

[131] Reg 2(i) of the Credit Amnesty Regulations.

5 Discussion

5.1 General comments on the evolution of affordability assessment as a measure to prevent reckless credit

The framework for the compulsory pre-agreement assessment to prevent reckless credit in terms of the National Credit Act progressed from the bare requirements cast in section 81 which required consideration of the consumers level of understanding of his risks, cost and obligations, his debt repayment history and his existing financial means, prospects and obligations without specifying the detail of such assessment, to one that is comprehensive and detailed. The approach with regard to pre-agreement assessment has clearly become more interventionist as is evident in the move from non-binding guidelines towards regulations that, once put into operation, will be binding on credit providers as minimum standards for assessment.

The May 2013 Draft Guidelines, being the first concrete steps towards clarifying the requirements for a section 81 assessment, was basically a ‘wish list’ that did not contain much detail regarding the requirements for the assessment, although it served to clarify the direction that the Regulator proposed to take as the first guideline pre-empted the introduction of the calculation norms in the September 2013 Draft Guidelines. The requirement of comprehensive consideration of all the consumer’s expenses and debt repayments that it proposed would enable the credit provider to have regard to a consumer’s complete debt situation which would provide a clearer picture of whether the consumer could afford the proposed credit. The introduction of a substantial adversity buffer[132] when calculating the consumer’s discretionary income that could be applied towards payment of the proposed credit represented a sound move towards shielding a consumer against over-indebtedness. The expansion on the credit provider’s assessment obligations by requiring credit providers to consult and to share credit application information would clearly allow for more accurate assessments. The imposition of a time limit on the assessment also served as a cautionary measure to limit the opportunity for a consumer to enter into other credit agreements without the agreement in respect of which the assessment is conducted having been loaded onto the consumer’s credit profile thereby limiting the incidence of consumers

[132] Analogous to s 9(1) Credit Agreements Act 75 of 1980, one of the NCA’s immediate predecessors (n 29).

obtaining further reckless credit as a result of an incomplete credit profile.

The regulatory reach of the assessment guidelines were expanded by the September 2013 Draft Guidelines which not only provided for definitive calculation norms but also imposed guidelines relating to credit literacy thus addressing means to increase consumer awareness and achieve better understanding of the implications of credit thereby serving to prevent the incidence of reckless credit granting to a consumer who does not understand his risks, costs and obligations under a credit agreement. These Guidelines also clearly sought to address the risk of reckless credit granting in the context of unsecured credit agreements which has been a major reason for the recent adversity that befell African Bank, causing the South African Reserve Bank to place African Bank under curatorship.[133] However, the distinction between unsecured and secured term credit agreements for purposes of constituting reckless credit where the credit was granted to a consumer who disclosed necessary living expenses below the minimum for his income band, but without credible proof, appears to be forced. The presence of security is not a failsafe indicator that the credit was not recklessly granted and it is submitted that the presence of security bears no relevance on whether credit was granted recklessly or not if no pre-agreement assessment was done or the consumer did not understand his risks, costs and obligations under the agreement or the consumer could in any event not afford the credit.

With regard to the requirement in the September 2013 Draft Guidelines that the credit provider must take all the consumer's debt into account as reflected on the credit bureau profile, it should be pointed out that cognisance ought also to be taken of the fact that a consumer may have other debt that may impact on his ability to afford credit which will not appear on his credit bureau record and that in order to have a complete picture of the consumer's debt situation the credit provider ought to ask the consumer to indicate any other debts not reflected on his credit profile and provide details of same.

The guideline that a credit provider is not required to verify the consumer's living expenses unless they fall below the minimum in Table 1 would ease the credit provider's burden to obtain information regarding the consumer's living expenses. The calculation norms based on the income bands as contained in Table 1 of the September 2013 Draft

[133] G Jones, 'African Bank in curatorship: sharing the pain', Financial Mail (14-20 August 2014) 24 ff, available at www.financialmail.co.za. In a media release the South African central bank also announced an investigation into African Bank, *inter alia* to ascertain whether or not it appears that any business of the latter was conducted recklessly. See https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=6396, 'accessed on 4 September 2014'.

Guidelines, however, attracted severe criticism in view thereof that they would foreclose a significant portion of the population, namely those consumers who fell within the income band below R14 000 per year, from access to credit.[134] It was surmised that consumers who would be cut off from access to credit would be forced to go 'underground' and thus would have to resort to loan sharks who would be prepared to grant them credit at exorbitant interest rates.[135]

The 2014 Draft Regulations, and by implication the largely similar Final Affordability Assessment Regulations of 2015,have both positive as well as negative features. It is to be welcomed that the 2014 Draft Regulations have not sought to retain the distinction made in the September 2013 Draft Guidelines in respect of unsecured and secured credit agreements and it also did not retain the provision that unsecured credit granted to consumers whose necessary expenses fall below that prescribed by Table 1 without credible supporting evidence constitute reckless credit. The requirement that 'practicable' steps be taken by the credit provider to assess the consumer's allocatable and discretionary income is contrary to the obligation imposed by the National Credit Act in section 81 which requires 'reasonable steps' to be taken and the wording of the Regulations will thus have to be revised to align it with the wording in the Act. The requirement in the 2014 Draft Regulations, as was also contained in the September 2013 Draft Guidelines, that the credit provider validates the consumer's gross income is inarguably a *sine qua non* for proper assessment. It is further to be welcomed that the range of expenses to be taken into account for purposes of calculating the consumer's living expenses has been significantly broadened beyond food, accommodation and transport as indicated in the September 2013 Draft Guidelines and the 2014 Draft Regulations accordingly represented a more realistic consideration of all the types of living expenses borne by consumers. The retaining of the minimum living expense standards for specified income bands, however, has a janus-faced quality: on the one hand it can be lauded for preventing reckless credit granting to consumers who cannot afford credit and mislead the credit provider about their living expenses in a bid to obtain credit whereas on the other hand it may be argued that such minimum living expenses may be exclusionary in nature and that a more individualised approach where no standard minimum living expenses are imposed, would make for more accurate and less exclusionary assessment. However, on a more positive note it may be remarked that at least Table 1 as it originally appeared in the September 2013 Draft Guidelines, has been revised and tapered down to set calculation norms which may be perceived as more realistic and less

[134] Compuscan Presentation on 'Amnesty and Affordability Guidelines', available at www.compuscan.co.za, 'accessed on 24 June 2014'.

[135] ibid.

exclusionary with regard to consumers who may access credit. The introduction of a questionnaire to 'verify' living expenses that are less than that which are provided for in Table 1 adds a good measure of flexibility to the assessment process and serves a dual purpose, namely to ensure that credit is not extended to consumers who present a toned down and inaccurate version of their living expenses in order to obtain credit but also to make it possible for consumers who are able to prove that their minimum living expenses fall below the amounts stated in the Regulations, to obtain credit.

The 2014 Draft Regulations also expanded on the obligations of the consumer with regard to pre-agreement assessment as it adds to the requirement that the consumer answer fully and truthfully as set out in section 81 of the Act, an obligation on the consumer to accurately disclose to the credit provider all financial obligations (thus also those that do not appear on his credit profile) to enable the credit provider to conduct an affordability assessment. This gives recognition to the fact that to impose responsible lending obligations on the credit provider without at least providing for some responsible borrowing obligations on a consumer defies the reality that whereas credit providers may be largely instrumental in granting reckless credit, consumers also play a role in many instances of reckless credit granting by not participating in good faith in the assessment process and not disclosing accurately all their financial obligations. It is, however, submitted that the distinction of 7 business days and 14 business days within which to refer to the consumer's debt repayment history appears artificial and the longer period afforded with regard to mortgage agreements might just increase the risk of reckless lending.

Although the 2014 Draft Regulations did not contain provisions relating to consumer literacy in the same terms as the September 2013 Draft Guidelines it should be noted that it did impose the obligation on the credit provider to ensure that the attention of the consumer is drawn to the credit cost multiple and that the cost of credit is understood by the prospective consumer. Consequently, although it did not address the risks and obligations under the agreement specifically, it at least seeks to ensure that the consumer understands the costs (which arguably may also constitute a risk to the consumer) and may thus contribute towards decreasing the incidence of reckless credit granting on the basis that a consumer did not understand the costs of credit as envisaged by section 80(1)(b)(i).

The introduction of a right for the consumer to lodge a complaint against the credit provider because he is aggrieved by the outcome of an affordability assessment is new and apparently seeks to ensure that consumers are not foreclosed from accessing credit because of an unfavourable outcome of an assessment that for instance failed to take cognisance of certain aspects required by the 2014 Draft Regulations. It can, however, be expected that credit providers will be opposed to retaining this provision in the 2014 Draft Regulations because, although the Regulations would set a minimum standard that the affordability assessment should meet, it would still be open to a credit provider to apply additional requirements and to extend credit that meets its risk appetite.[136] It might also be argued that this provision is contrary to the clear provisions of section 60 of the Act which give the consumer a right to apply for credit and section 62 which gives the consumer the right to reasons for refusal of credit but neither of which gives the consumer a right to get credit. In any event this provision may likely also not serve the interests of the consumers whom it seeks to protect as they may become embroiled in lengthy proceedings during which period they are in any event without the credit they sought.

Kelly-Louw commented on the May 2013 Draft Guidelines and expressed some valid reservations, *inter alia* that the introduction of fixed percentages of discretionary income in accordance with specified income bands might unnecessarily marginalise certain consumers and cut them off from access to credit.[137] She furthermore indicated that this type of fixed percentage model also does not cater for consumers who are willing to scale down their living standard in order to afford the credit.[138] It appears that the aforementioned concerns have subsequently been addressed to a considerable extent insofar as the income bands in Table 1 of the 2014 Draft Regulations were much less exclusionary than those proposed in the September 2013 Draft Guidelines. The Regulations also introduced the opportunity for consumers to escape the restrictions of the required minimum living expenses that must be taken into account by the credit provider for purposes of assessment by allowing the consumer to prove that his living expenses are below the minimum living expense standard. Notably, however, the Regulations introduce checks and balances on an allegation by a consumer that his living expenses fall below the minimum for his specific income band by requiring the consumer to provide details of his living expenses in a questionnaire and requiring the credit provider to ensure that the questionnaire is completed and considered before extending credit to such a consumer.

The 2015 Final Affordability Assessment Regulations are largely similar to the 2014 draft regulations with a few minor exceptions as indicated above – thus the aforementioned comments regarding the 2014 regulations also apply to the final regulations. It appears that

[136] S 61(5), discussed above, is also of importance in this respect.

[137] Kelly-Louw 36.

[138] ibid.

the final regulations marginally increases the obligation of the consumer to engage in responsible borrowing by obliging the consumer to provide (and not merely disclose) authentic documentation to enable the credit provider to conduct an affordability assessment. Table 1 has been slightly revised and the regulations now set out the methodology for the application of the Table[139] and make it clear that utilization of the minimum expense norms set out in the table is peremptory when calculating the financial obligations of consumers. The complaint procedure that a consumer who is aggrieved by the outcome of an affordability assessment should follow is also set out in more detail and time limits are added to the process.

At this stage it is submitted that it is unclear exactly what impact the Credit Amnesty Regulations may have on the credit provider's ability to conduct a proper assessment, even if the credit provider religiously sticks to the requirements set out in the Affordability Assessment Regulations.

5.2 The extension of the Tribunal's powers with regard to reckless credit

The National Consumer Tribunal has become 'mightier' than the courts with regards to its powers in respect of reckless credit. Not only can it impose severe administrative fines (which the courts are not empowered to do) and order the cancellation of a credit provider's registration (which a court can only deal with if the said cancellation is for instance appealed against) but its powers have been amplified by the National Credit Amendment Act so that it can now exercise the same powers with regards to reckless credit as the courts. It should also be borne in mind that an order by the Tribunal has the same status as an order of the high court.[140] It may be asked what significance the elevation of the role of the Tribunal in the context of reckless credit holds. For starters one needs to appreciate the fact that the process before the Tribunal entails very little costs, especially as the consumer can appear in person, there appears not to be problems with delay and the procedure in the Tribunal is informal and inquisitorial[141] in nature. By contrast the procedure before the courts is costly, often marked by excessive delay and are adversarial in nature. Granted, the Tribunal is a single body comprised of a handful of presiding members that sit on an *ad hoc* basis and

[139] When Table 1 was introduced by the September 2013 guidelines it was accompanied by an example setting out how the table should be applied but this explanation was absent from the 2014 draft guidelines.

[140] S152 of the Act.

[141] S142 of the Act.

since the coming into operation of the Consumer Protection Act[142] on 31 March 2011 their workload has doubled whereas at entry level for purposes of NCA litigation there are magistrates courts in every district, regional courts for specific regions, high courts for various divisions - thus creating a court system that is on face value able to proportionately absorb reckless credit claims by consumers or deal with reckless credit defences raised by consumers. However if one consults the website of the Tribunal it soon becomes clear that the Tribunal hears and delivers judgment in a large number of cases annually.[143]

On a practical level one might wonder how this concurrent reckless credit jurisdiction of the civil courts and the Tribunal will play out. The dearth of reported cases where a consumer has approached the courts as a plaintiff with a claim that credit was granted recklessly as opposed to the number of reported cases where consumers raised reckless credit as a defence to enforcement proceedings instituted by a credit provider justifies the inference that consumers do not generally pursue reckless credit as a cause of action but rather wait until they are sued and then use it as a defence against enforcement proceedings.[144] In a way this makes sense, especially in the context of type three reckless credit as those consumers will be financially overstretched and not likely to be able to afford to institute proceedings to address the reckless credit granting. Thus they would rather 'piggy back' on the enforcement proceedings that are instituted against them by the credit provider as those proceedings will in any event involuntarily have drawn them into the costly cycle of litigation.

It may be asked whether consumers will now flood the Tribunal with claims of reckless credit. Until now consumers generally approached the Tribunal with issues such as disputed sale of goods in terms of section 128 and disputed entries on accounts in terms of section 111 of the Act. Does the power of the Tribunal to *suo motu* raise the issue of reckless credit mean the Tribunal will, even in matters not aimed at obtaining relief from reckless credit, now of its own accord raise and investigate the aspect of reckless credit granting? It is submitted the Tribunal, like the courts, will not now in matters where the consumer has not specifically instituted proceedings to obtain a declaration of reckless credit, go on an arbitrary quest to eradicate reckless credit granting but that one can expect that it will address the issue of reckless credit if it is raised by or on behalf of a consumer during proceedings before it and will only *suo motu* raise the issue of reckless credit if there is something in the facts of a specific case that would 'put it on enquiry'.

[142] Act 68 of 2008.

[143] For a list of the cases heard by the Tribunal consult their website at www.thenct.org.za.

[144] For an overview of the cases where reckless credit was raised as a defence see Guide to the National Credit Act par 11.4.

Does the extension of the Tribunal's powers to make declarations of reckless credit and order debt relief mean that consumers will be able to thwart efforts by credit providers to exercise their rights to enforce credit agreements through the courts? Thus, if a consumer takes the bold step to approach the Tribunal to obtain a declaration of reckless credit prior to the institution of enforcement proceedings by the credit provider what is the effect thereof on enforcement proceedings that have not yet been instituted? Section 130(3)(b) provides that, despite any provision of law or contract to the contrary, the court may determine the matter only if it is satisfied, *inter alia*, that 'there is no matter arising under that credit agreement, and pending before the Tribunal, that could result in an order affecting the issues to be determined by the court'. Section 130(4)(d) of the Act is further relevant as it provides that in any debt procedures before a court, if the court determines that there is a matter pending before the Tribunal, as contemplated in section 130(3)(b) then the court has a discretion to adjourn the matter before it, pending a determination of the proceedings before the Tribunal.[145]Alternatively the court may order the Tribunal to adjourn the proceedings before it, and refer the matter to the court for determination.[146] A determination of reckless credit is clearly a matter that may result in an order affecting the issues to be determined by the court during enforcement proceedings. It is submitted that the courts will not interfere lightly with a matter relating to reckless credit that is pending before the Tribunal, especially as orders by the Tribunal has the same status as orders of the high court. A court cannot however merely because a matter relating to reckless credit is pending before the Tribunal, as a matter of course rule that the enforcement proceedings instituted in the court should be adjourned so that the Tribunal can make a determination regarding reckless credit. A court will have to exercise the discretion afforded by section 130(4)(d) judicially having regard *inter alia* to the evidence that has already been presented to the Tribunal on the issue of reckless credit and the stage to which the Tribunal's enquiry into the issue of reckless credit has progressed. If the issue of reckless credit can be more conveniently dealt with by the court that is also a factor that should be taken into consideration.

6. Conclusion

The NCA recognizes that responsible lending and responsible borrowing go hand in hand although the obligations it imposes on credit providers by far outweigh the obligations placed on consumers in this regard. Consumers are thus not only protected and but also 'responsibilised' by this regime.

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[145] S130(4)(a).

[146] S130(4)(b).

With the National Credit Amendment Act and final Affordability Regulations now in force credit providers will have to re-evaluate their assessment practices to ensure that it, as a minimum complies with the binding requirements set out in the regulations, in order to avoid the sanctions attracted by reckless credit. They will also have to be mindful of the implications of the extended powers that have been conferred upon the Tribunal by virtue of the amendments by the National Credit Amendment Act to section 83 and of how this may potentially impact upon enforcement of their credit agreements.

The preferent claim of local authorities ito s 118 of the of the Local Government: Municipal Systems Act

Sieg Eiselen

A. Introduction

Section 118 of the Local Government: Municipal Systems Act 32 of 2000 LGMSA creates a preferent claim in favour of local authorities for unpaid municipal service fees, surcharges on fees, property rates and other municipal taxes, levies and duties. A recent case has highlighted the difficulties these provisions create. In *Mitchell v City of Tshwane Metropolitan Municipal Authority* [2014] JOL 32395 (GP) the Gauteng Pretoria Division of the High Court the court had to decide whether the tacit statutory hypothec created in terms of s 118(3) of the Local Government: Municipal Systems Act is extinguished by a sale in execution, leaving municipalities with only a right of recourse against the proceeds of the execution or not and whether a municipality can refuse to provide services to a successor in title because historical debts against the property are still outstanding.

B. Provisions of the LGMSA

Section 118 of the LGMSA reads as follows:

> *118. Restraint on transfer of property.—(1) A registrar of deeds may not register the transfer of property except on production to that registrar of deeds of a prescribed certificate—*
> *(a) issued by the municipality or municipalities in which that property is situated; and*
> *(b) which certifies that all amounts that became due in connection with that property for municipal service fees, surcharges on fees, property rates and other municipal taxes, levies and duties during the two years preceding the date of application for the certificate have been fully paid.*
> *(1A) A prescribed certificate issued by a municipality in terms of subsection (1) is valid for a period of 60 days from the date it has been issued.*
> *(2) In the case of the transfer of property by a trustee of an insolvent estate, the provisions of this section are subject to section 89 of the Insolvency Act, 1936 (Act No. 24 of 1936).*
> *(3) An amount due for municipal service fees, surcharges on fees, property rates and other municipal taxes, levies and duties is a charge upon the property in connection with which the amount is owing and enjoys preference over any mortgage bond registered against the property.*
> *(4) Subsection (1) does not apply to—*
> *(a) a transfer from the national government, a provincial government or a municipality of a residential property which was financed with funds or loans made available by the national government, a provincial government or a municipality; and*
> *(b) the vesting of ownership as a result of a conversion of land tenure rights into ownership in terms of Chapter 1 of the Upgrading of Land Tenure Rights Act, 1991 (Act No. 112 of 1991): Provided that nothing in this subsection precludes the subsequent collection by a municipality of any amounts owed to it in respect of such a property at the time of such transfer or conversion.*
> *(5) Subsection (3) does not apply to any amount referred to in that subsection that became due before a transfer of a residential property or a conversion of land tenure rights into ownership contemplated in subsection (4) took place.*

Subsection 1 is well known in practice as it is a requirement for all transfers of immovable property that a municipal clearing certificate must be provide to the Registrar of Deeds. In the absence of such a certificate the Registrar will reject the transfer until such time as the clearance certificate is produced. It is not clear where the two year term referred to in section 118(1) originates from and it is certainly discordant with the three year general prescription term that would apply to all amounts owing to the local authority other than taxes. Certainly, requiring a clearance certificate that covered three years preceding the transfer would have made more sense. The position therefore is that the clearance certificate may only relate to the preceding two years of historical debts which may leave at least one more year of potential debts which have not prescribed and which may remain unpaid.

Subsection (3) creates a statutory lien or preferent right which enjoys preference over mortgage bonds registered against the property. Despite this statutory real right which exists in favour of local authorities, properties are transferred to third parties on a daily basis where historical debts may still be outstanding, because the clearance certificate only relates to the preceding two years as the Mitchell case illustrates.

C. Mitchell v City of Tshwane Metropolitan Municipal Authority [2014] JOL 32395 (GP)

The facts of the Mitchell case were as follows: Mitchell purchased immovable property at a sale in execution in the Tshwane municipal area. Before the purchase of the immovable property the Tshwane municipality had issued a certificate indicating the total outstanding debt in terms of both sections 118(1) and 118(3). After the amount was queried, Tshwane municipality issued a more detailed certificate distinguishing between s 118(1) and s 118(3) debts.

After taking transfer, Mitchell sold the property to Prinsloo. When Prinsloo applied for the supply of municipal services on the property, the municipality refused, stating that it will only enter into an agreement once the historical debts (in terms of s 118(3)) have been paid. Prinsloo refused to proceed with the sale and the transfer of the property unless the issue regarding the payment of historical debts were dealt with. This prompted Mitchell to apply for a declaratory order that "the lien" held in terms of LGMSA s 118(3) over his immovable property, did not pass upon the transfer of the property to his successor in title; that his successor in title is furthermore not liable for the historical municipal debts of the previous owners (before Mitchell); and that the municipality must open an account in the name of Mitchell and his successors in title for the supply of municipal services to the immovable property.

Mitchell argued that the s 118(3) debt was "a charge upon the property", and as such should be enforced over the proceeds of the property and against the previous owner only.

The Tshwane municipality could therefore not hold Mitchell and his successors in title liable for debts incurred by previous owners. The municipality therefore had to open the account in the name of Mitchell and his successors in title.

Tshwane municipality argued that the security provided was a charge upon the property and as such secured by the property. The security should therefore survive transfer in title and was as such enforceable against successors in title. As long as the debts remained unpaid, the municipality could refuse to open an account.

The Court held as follows:

- Section 118(3) is a real right of security created by statute in favour of the municipality. As such, while the principle debt is still outstanding, transfer in the normal course of business does not terminate the right. This is clear from the decisions in *City of Tshwane Metropolitan Municipality v Mathabathe* 2013 4 SA 319 (SCA) and *BOE Bank Ltd v Tshwane Metropolitan Municipality* 2005 (4) SA 336 (SCA).
- The position is different when immovable property is sold in execution. Upon sale in execution, the hypothec over the unmovable property is extinguished and the new owner gets a clean title. This rule is based on the common law.
- The Tshwane municipality had to be aware of the sale in execution as it was asked to issue a section 118(1) certificate. If the municipality had acted then, it could have exercised its rights of preference over the proceeds of the property.
- The principle obligation for the debt, however, remained. This implies that the person who incurred the debts were still liable for them.
- Section 118(3) furthermore does not create an agreement between the new owner to become jointly liable with regard to the principle debt. The property is only held as security for the payment of the debt as a “charge upon the property”. It creates a tacit statutory hypothec as a form as real security.
- Neither the Electricity nor the Water Bylaws of the municipality refers to successors in title. All definitions and provisions in these bylaws indicate that the person liable for the historic debts is the owner of the property at the time when the services were supplied.
- The municipality could therefore not refuse to supply services to a successor in title.

D. BOE Bank Ltd v Tshwane Metropolitan Municipality 2005 (4) SA 336 (SCA)

In this case the dispute between the parties arose from competing claims by the appellant ('the bank') and the respondent ('the municipality') to the proceeds realised from a sale in execution of immovable property situated at Wonderboom, Pretoria ('the property'). The bank's claim was based on mortgage bonds over the property while the municipality's claim was for municipal rates and for services rendered in connection with the property. In contention was the proper interpretation of section 118(3) of the LGMSA.

The facts were quite straightforward. he previous owners of the property were Mr and Mrs Van Heerden. Between 1994 and 1996, the bank's predecessor-in-title, NBS Bank Limited, registered three mortgage bonds over the property securing loans in a total amount of more than R2,3m. During the period 1994 to 2001 the previous owners also became indebted to the municipality for property rates, municipal services and other charges contemplated in ss 118(1) and 118(3). In June 2001 NBS Bank took judgment against the Van Heerdens for money lent and advanced under the mortgage bonds. In terms of the judgment the property was declared executable.

Towards the end of October 2001, the attorneys appointed to attend to the transfer of the property pursuant to the sale in execution, applied to the municipality for the clearance certificate contemplated by s 118(1) of the Act. The certificate issued by the municipality showed an amount of R287 900,29 owing in respect of municipal rates and services for the two years preceding the date of application for the certificate, ie since October 1999. The same certificate, however, also reflected a further amount of R655 273,83 outstanding in respect of municipal debts that became due prior to October 1999.

At the sale in execution, which was held in December 2001, the property was sold for R725 000. In terms of the conditions of sale the purchaser also undertook to pay various amounts apart from the purchase price, including 'any charges necessary to effect transfer' of the property. It is common cause that the purchaser thus became liable to pay the amount of R287 900,29 certified to be owing in respect of the two year period since October 1999. Consequently there is no dispute about this amount. It has been paid by the purchaser. The dispute concerned the historical debt.

The court held as follows:

- In considering whether the time limit stipulated in s 118(1) should be read into s 118(3), it must be borne in mind that the two sections provide the municipality with two different remedies. Although the purpose of both is to ensure payment of the municipal claims that fall within the stipulated category, the mechanisms employed to achieve that purpose are different.
- Section 118(1) is an embargo provision affording the municipality a right to veto the transfer of property until its stipulated claims are met, they do not render the municipality's claim preferent to existing mortgagees in the case of a sale in execution.
- Section 118(3) creates a tacit statutory hypothec in favour of the local authority.

- Section 118(3) is on its own wording an independent, self-contained provision. It does not require the incorporation of the time limit in s 118(1) to make it comprehensible or workable.

E. Comments

In the Mitchell case the court indicated in paragraph [9] that generally speaking there is no reason why transfer in the normal course of business should terminate the tacit hypothec created in favour of the local authority in terms of section 118(3). This would mean that a new owner could later be held liable for such debts which have not prescribed if the original owner and debtor has been excussed and the property declared executable. The court relies on the *Mathabathe* case (*supra*) for this statement where the court in paragraph [12] indeed creates this impression. This conclusion has important consequences for subsequent owners as well as bond holders as the owner may become indirectly liable for the payment of someone else's debt through the sale in execution of the property. It also may have serious unintended consequences for bondholders whose security may not be as valuable as they had thought due to the existence of the municipal debt of which they may be unaware.

The broad statement of the court must be qualified though as it seems that the courts did not consider the impact of section 118(5) of the LGMSA. In terms of this provision the real right afforded by subsection 118(3) does not extend to any amount referred to in subsection 3 that became due before the transfer of a residential property. In other words, in the case of a residential property the real right of the municipality is extinguished, even though it is sold in the ordinary course of business. This conclusion is contrary to the decision in the *Mitchell* and *Mathabathe* cases (*supra*).

The statements of the courts are however correct in respect of real rights over commercial properties. In this case the real right will survive a transfer in the ordinary course, but not where the property is sold on auction in accordance with the decision in the *Mitchell* case.

The following consequences must be reckoned with by buyers and bondholders of commercial properties:

- Where a property is sold in the ordinary course of business, the property is sold subject to any existing municipal lien that may exist at that time. The seller is liable to the buyer if the existence of the lien is not disclosed prior to the sale as a latent defect in the property. The local authority has no recourse to the bond holder where the proceeds of the sale have been paid to the bond holder as the lien is not extinguished by the sale.

- Where the property is sold in execution, the local authority has a preferent claim for all historical debts ito s 118(3). If the proceeds of the execution sale has been paid to a bond holder, the local authority may have a claim against the bond holder for any amounts it received but which are in fact owed to the local authority for historical debts.
- Where there are substantial outstanding municipal debts, as in this case and in the BOE Bank case, it may be in the interest of a bond holder to cause a private sale to take place rather than a forced sale if a yield may be achieved that will take care of the municipal debt as well as the bond amount. This requires careful management of the enforcement procedures iro bond debts.
- Historical debts will prescribe after three years in municipal services and fees, but only after 30 years in respect of rates and taxes.

The common law enrichment claim in the context of section 85(9) of the National Credit Act

Alwyn Möller *

1. Introduction

The National Credit Act 34 of 2005 ("Act") contains numerous prohibitions against the conclusion of credit agreements by credit providers, unless certain requirements of the Act are complied with.

This paper deals with the amendment of section 89(5) that directs that if a credit agreement is unlawful in terms of section 89, a court must make an order that is just and equitable, and including but not limited to, that the credit agreement is void.[1] In its amended form it provides as follows: (5)

> *If a credit agreement is unlawful in terms of this section, despite any other legislation or any provision of an agreement to the contrary, a court must <u>make a just and equitable order including but not limited to an order</u> that-*
> *(a) the credit agreement is void as from the date the agreement was entered into.*

The amendment of section 89(5) resolved challenges to the provisions of section 89(5)(b) and (c) (scrapped in the amendment) that were held to be inconsistent with the right not to be arbitrarily deprived of property as recognised in s 25(1) of the Constitution. Before amendment section 89(5) provided as follows:

> *If a credit agreement is unlawful in terms of this section, despite <u>any provision of common law</u>, any other legislation or any provision of an agreement to the contrary, a court must order that-*
> *(a) the credit agreement is void as from the date the agreement was entered into;*
> *(b) the credit provider must refund to the consumer any money paid by the consumer under that agreement to the credit provider, with interest calculated-*
> *(i) at the rate set out in that agreement; and*
> *(ii) for the period from the date on which the consumer paid the money to the credit provider, until the date the money is refunded to the consumer; and*
> *(c) all the purported rights of the credit provider under that credit agreement to recover any money paid or goods delivered to, or on behalf of, the consumer in terms of that agreement are either-*

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[1] Government Gazette Nr 3855 of 13 March 2015: National Credit Amendment Act (19/2014): Commencement of the National Credit Amendment, Nr R10, 2015.

(i) cancelled, unless the court concludes that doing so in the circumstances would unjustly enrich the consumer; or
(ii) forfeit to the State, if the court concludes that cancelling those rights in the circumstances would unjustly enrich the consumer.

Two court challenges were based firstly on the (arbitrary) denial under section 89(5)(c) of an unregistered credit provider's right to claim on the basis of unjustified enrichment the money lent out under a void agreement, without affording a court the discretion to consider whether restitution would be just and equitable.[2] The challenge was successful and section 89(5)(c) was thus declared invalid.

The second challenge was in relation to section 89(5)(b) which, without affording a court the discretion to consider whether restoration of performances would be just and equitable, compelled the court to order repayment by the unregistered credit provider to the consumer of all amounts paid by the consumer under the void agreement, with interest. It was argued *inter alia* that this compulsory statutory repayment amounted to an arbitrary deprivation of ownership.[3] The availability of a claim based on unjustified enrichment subsequent to the *Opperman* judgement was raised in *Wilson*. An order providing for reformulation in accordance with the amendment was agreed to between the parties.

The WCHC declared section 89(5)(b) to be invalid and unconstitutional and issued an order, agreed to between the parties, in terms whereof section 89(5) was reformulated in accordance with its current amended format (as above, then pending).

2. **The position after 13 March 2015**

The result of the amendment is that the common law remedy based on unjustified enrichment is no longer excluded under section 89(5) and that the restoration of performances, if any, reverts to jurisdiction of the court. Additionally, the court is empowered and directed in express terms to make orders on just and equitable grounds, when the agreement is confirmed as void from inception.

[2] *National Credit Regulator v Opperman & Others* 2013 (2) SA 1 (CC); read with *Opperman v Boonzaaier & Others* (WCC) case no 24887/2010, 17 April 2012.

[3] *Chevron SA (Pty) Ltd v D.E. Wilson & 3 Others (WCC)* 2544/2013, judgment on 5 June 2014 per Baartman J. In the confirmation proceedings, the Constitutional Court reserved judgment on 24 March 2015 in *Chevron SA (Pty) Ltd v Dennis Edwin Wilson t/a Wilson's Transport and Others* CCT88/14 ("*Wilson*").

The discussion below entails that the effect of the amendment amounts to more than a mere reinstatement of the common law position that had prevailed prior to the enactment of section 89(5) on 1 June 2007.

It is also considered that section 89(5) may provide scope for the determination of claims on just and equitable grounds, beyond the narrow constraints of the common law *condictio ob turpem vel iniustam causam.* The harsh effects of the maxim *ex turpi causa non oritur actio* and the compounding *in pari delicto potior conditio possidentis vel defendentis* rule (*par delictum* rule) may be tempered with an order that is just and equitable. It follows that the court is provided with equitable jurisdiction, beyond the ambit of the common law.

The determination of what is just and equitable between the parties to the order, when undertaken with sufficient material before the court (it is submitted with respect), may serve to extend and amplify the jurisdiction of the court exercised on the consideration of a claim based on unjustified enrichment and in turn develop the law on just and equitable grounds.

An order that is just and equitable lies in the apparently wide and uncircumscribed discretion of the court and conceivably would relate to matters of both a procedural and substantive law nature.

It is proposed herein that the scope of such a just and equitable order will ultimately be determined with reference to the common law, public policy, justice and fairness, the purposes of the Act and the norms and values in the Constitution.[4]

3. Unlawful agreements and the National Credit Act

Instances of unlawfulness under section 89 include the prohibited conclusion of a credit agreement by a credit provider [5] where the credit provider is required to be registered.[6]

As a general rule, the law will not give effect to an agreement concluded against the prohibition of the law.

[4] *Carmichele v Minister of Safety & Security* 2001 (4) SA 938 (CC) at paragraph [56].

[5] The other prohibitions relate to credit agreements with unassisted unemancipated minors, mentally unfit persons and unauthorised persons under an administration order, agreements procured through negative option marketing and unlawful supplementary agreements or when a credit provider was notified cease providing credit.

[6] Section 40(1),(3) and (4) read with section 89(2) and (5)(a) as amended.

> "It is a fundamental principle of our law that a thing done contrary to the direct prohibition of the law is void and of no effect. … So that what is done contrary to the prohibition of the law is not only of no effect, but must be regarded as never having been done - and that whether the lawgiver has expressly so decreed or not; the mere prohibition operates to nullify the act." [7]

Under the common law, generally an agreement concluded against a statutory prohibition is regarded as unlawful and will be unenforceable from inception, as expressed in the maxim *ex turpi causa non oritur actio*.

The anticipated consequences of orders of unlawfulness issued under section 89(5) and in particular what is to be regarded as "just and equitable" must be considered and determined against the purposes of the Act and its proper context.

It has been held that agreements are contrary to public policy, if it is opposed to the interests of the State, or of justice, or of the public, and that agreements which are "clearly inimical to the interests of the community, whether they are contrary to law or morality, or run counter to social or economic expedience, will accordingly, on the grounds of public policy, not be enforced."[8]

A distinction can be drawn between agreements that either is void by reason of the lack of compliance with formalities, or that is concluded against an express prohibition of law.[9] In a broader context, the consequences of illegal or unlawful agreements may be determined by the nature of the legal prohibition or constraint in the context of a statute. Whether an agreement or action is void and with no legal consequence, will depend upon the proper construction of the particular legislation.[10]

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[7] *Schierhout v Minister of Justice* 1926 AD 99 at 109; *Cool Ideas 1186 CC v Hubbard* 2014 (4) SA 474 (CC) (2014 (8) BCLR 869; [2014 ZACC 16]) at [48].

[8] *Sasfin (Pty) Ltd v Beukes* 1989 (1) SA 1 (A) at 8C – D. Categorising the conduct as immoral, unlawful or illegal is not helpful as these instances of conduct often overlap on consideration of public policy.

[9] *Oilwell (Pty) Ltd v Protec International Limited & Others* 2011 (4) SA 394 (SCA). Failure to obtain prior treasury consent for an agreement whereby capital or any right to capital is directly or indirectly exported from the Republic does not necessarily render the agreement void, paragraphs 15, 23, 24, 25.See *Legator McKenna Inc v Shea* 2010 (1) SA 35 (SCA) at paragraphs [26], [27] to [30]. Compare with section 28(2) of the Alienation of Land Act 68 of 1981 "Any alienation which does not comply with the provisions of section 2 (1) shall in all respects be valid ab initio if the alienee had performed in full in terms of the deed of alienation or contract and the land in question has been transferred to the alienee."

[10] "*In die algemeen word 'n handeling wat in stryd met 'n statutêre bepaling verrig is, as 'n nietigheid beskou, maar hierdie is nie 'n vaste of onbuigsame reël nie. Deeglike oorweging van die bewoording van die statuut en van sy doel en strekking kan tot die gevolgtrekking lei dat die Wetgewer geen nietigheidsbedoeling gehad het nie." Swart v Smuts* 1971 (1) SA 819 (A) at 829C – G with references to authorities omitted; *Lupacchini NO v Minister of Safety & Security* 2010 (6) SA 457 (SCA) at paras 8 and 9 and the authorities cited at note 10.

The consequences of an unlawful agreement may be regulated by the relevant statute, as the National Credit Act does in some instances, and may provide sanctions and remedies where there has been noncompliance. These various consequences in the Act differ with reference to the specific type of prohibition.

The result is that in some instances, other than under section 89, that the agreement is not void and unenforceable, without more. These varying consequences provisions can assist in the process of interpreting the Act and to determine what may be regarded as "just and equitable".

4. Interpretation of the Act

The proper approach to the construction of a provision is that it must be construed (a) purposively, (b) in context and (c) consistently with the Constitution. Where reasonably possible, an aberrant legislative provision ought to be interpreted to preserve its constitutional validity.[11] This enquiry, it is submitted must be a unitary approach, connected to the recognised purposes[12] and the context of the provision considering all of these facets and the court

> "… must seek to promote the spirit, purport and objects of the Bill of Rights. We must prefer a generous construction over a merely textual or legalistic one in order to afford claimants the fullest possible protection of their constitutional guarantees. In searching for the purpose, it is legitimate to seek to identify the mischief sought to be remedied. In part, that is why it is helpful, where appropriate, to pay due attention to the social and historical background of the legislation. We must understand the provision within the context of the grid, if any, of related provisions and of the statute as a whole, including its underlying values. Although the text is often the starting point of any statutory construction, the meaning it bears must pay due regard to context. This is so even when the ordinary meaning of the provision to be construed is clear and unambiguous."[13]

It follows that the approach on the interpretation will require a consideration of the purposes and context the provision, consistent with the Constitution. The common law must also be considered in this sometimes tenuous relationship between Constitution and statute, and this will in turn reveal, if not determine public policy. On the relationship between the Constitution, common law and statute:

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[11] *Cool Ideas 1186 CC v Hubbard* 2014 (4) SA 474 (CC) para [28] and the authorities cited.

[12] The purposes of the Act are defined in the Act and require no discussion in this context.

[13] With added emphasis: *Department of Land Affairs and Others v Goedgelegen Tropical Fruits (Pty) Ltd* 2007 (6) SA 199 (CC) (2007 (10) BCLR 1027; [2007] ZACC 12) para [53]. Remedial legislation is "umbilically linked to the Constitution".

> "The legislature may of course codify, deviate from, change, or abolish parts of the common law. The Constitution is the supreme law of the land. The common law and statute law must be consistent with it."[14]

Further, where tension arises between a common law principle or a remedy and a statutory provision, or between common law remedies, such tension must be resolved in a manner consistent with the Constitution, as confirmed in *Opperman*. The Constitution may not always provide a direct or definitive solution, but must be applied as the touchstone to resolve such tension.

5. Unjustified enrichment and the *condictio ob turpem vel iniustam causam*

The maxim *ex turpi causa non oritur actio* may give rise to harsh consequences, unjust or iniquitous results, where the parties under the void agreement had performed and, for example, incomplete or unbalanced performances had been exchanged while the parties, or a party, may have acted in good faith or in justifiable ignorance of the law.

The enrichment action *condictio ob turpem vel iniustam causam* is available where money or other property was transferred in terms of an unlawful agreement.

The general requirements for the action based on enrichment can be stated as follows:

(a) the defendant must be enriched;
(b) the plaintiff must be impoverished;
(c) the defendant's enrichment must be at the expense of the plaintiff; and
(d) the enrichment must be unjustified.[15]

Also, the plaintiff must tender return what was received, no other remedy must be available; the claim must be recognised in law (fit a category of enrichment claim), the plaintiff must have acted honourably or without turpitude. The quantum of the enrichment claim will be the lesser of either the amount of enrichment or of the impoverishment.[16]

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[14] *Opperman supra* at paragraph [13].

[15] *Capricorn Beach Home Owners Association v Potgieter t/a Nilands and Another* 2014 (1) SA 46 (SCA) for the first four requirements at para [20]; *McCarthy Retail Ltd v Shortdistance Carriers CC* 2001 (3) SA 482 (SCA) at para 496E.

[16] Lawsa Vol 98, 2nd Edition, *Enrichment*, paragraph 209 at 111-113. Daniel Visser, *Unjustified Enrichment* Juta 2011 reprint at pp 4 to 6. Du Plessis *The South African Law of Unjustified Enrichment* (Juta & Co, Cape Town 2012) at 195 to 213 on the *condictio ob turpem vel iniustam causam. Kudu Granite Operations (Pty) Ltd v Caterna Limited* 2003 (5) SA 193 (SCA) at para 17.

Generally enrichment claims are available to restore an economic benefit to a plaintiff at whose expense these benefits were obtained and where no legal justification exists for the retention of that benefit by the other party.[17]

The ancient casuistic nature of the sources and authorities reveal as discussed by our courts reveal that "the formal exercise of determining which condictio is applicable to which problem" is to the detriment of the real function of the law that ought to be establishing whether or not there was enrichment that was unjustified.[18] Such actions include the *condictio indebiti* (e.g. to recover or performance of payment of a non-existent debt or obligation); the *condictio sine causa* (broadly where there is no cause, such as where compensation was made based on a mistaken assumption or supervening impossibility of performance); *condictio causa data causa non secuta* (the anticipated cause does not arise with undue performance made).[19]

As the function of an enrichment action is aimed at achieving *restorative justice* as "*an equitable desirability*"[20] the use of the "just and equitable order" may serve to allow the development of the law towards the recognition of a general enrichment action untrammelled by the common law *numerus clausus*,[21] or at the least in the immediate statutory context of the *condictio ob turpem vel iniustam causa* under section 89(5).

> *"(I)t must be recognised that the fact that enrichment liability is largely about corrective justice, which normally corrects an unjustified gain which is mirrored by an unjustified loss, does not mean that the mirror loss is an indispensable element. The fact that corrective justice presumes a correlative relationship between gain and some form of injustice does not mean that the injustice should consist of economic loss."*[22]

It is submitted that where court is required under section 89(5) to exercise its jurisdiction to make an order that is just and equitable, the court may issue orders, beyond the relief claimable under the *condictio ob turpem vel iniustam causam*, and

[17] Visser, *Unjustified Enrichment* at pp 4 to 6. De Vos *Verrykingsaanspreeklikheid in die SA Reg* Third edition Juta at 28

[18] *McCarthy Retail Ltd v Shortdistance Carriers CC* 2001 (3) SA 482 (SCA) para 10. The reconition of a general action was declined in *Nortje v Pool* 1966 (3) SA 96 (A), and in *Afrisure CC v Watson NO* 2009 (2) SA 127 (SCA) at para [4]; Graham Glover, *Reflections on the sine causa requirement and the condictiones in South African law*, 2009 Stell LR 468 at 475 – 477.

[19] There are several other *condictiones.* See De Vos *Verrykingsaanspreeklikheid in die SA Reg* Third edition Juta at 10 -35 and following ; 154 -212 and following.

[20] Glover supra at 475.

[21] First National Bank of Southern Africa Ltd v Perry NO 2001 (3) SA 960 (SCA) at para [23].

[22] Visser *supra* at 22.

furthermore beyond the strict requirements for an enrichment action and including in relation to the calculation of the amount of the unjustified enrichment, or the impoverishment.

6. The *par delictum* rule

Under the common law the rule *in pari delicto potior conditio possidentis vel defendentis* or the *par delictum* rule determines that the party in possession (the defendant) is in a stronger position where the parties are equally in the wrong. This means the claim is not recognised and the parties have no claims against each other.

When applying the *ex turpi causa* maxim and the *par delictum* rule to claims based on enrichment claims, it is clear that conflicting considerations of public policy will arise, as may iniquitous consequences[23] – on the one hand, parties ought not to be allowed to claim under illegal and unlawful agreements; but on the other hand no one should be allowed to benefit from their own unlawful conduct, or be unjustifiably enriched.[24]

Such consequences must be considered against public policy, but of course must be informed by and be consistent with the Constitution with reference to the Act generally and the purposes of the prohibition, more specifically.

7. Relaxation of the *par delictum* rule

Under the common law, as it was developed, the *par delictum* rule is recognised to be subject to exceptions, based on considerations of public policy:

> "… *public policy should properly take into account the doing of simple justice between man and man. … Courts of law are free to reject or grant a prayer for restoration of something given under an illegal contract, being guided in each case by the principle which underlies and inspired the maxim. And in this last connection I think a Court should not disregard the various degrees of turpitude in delictual contracts. … And it follows from what I have said above, in cases where public policy is not foreseeability affected by a grant or refusal of the relief claimed, that a Court of law might well decide in favour of doing justice between the individuals concerned and so prevent unjust enrichment".*[25]

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[23] Otto JM *Die Par Delictum-Reël en die National Credit Act* (2009) 3 TSAR 417 at 417-8 and in particular at 422 to 428 and following; Otto JM *National Credit Act, Ongeoorloofde Ooreenkomste en Meevallertjies vir die Fiscus* (2010) 1 TSAR 161 at 162 – 3.

[24] *National Director of Public Prosecutions* v Phillips and others 2002 (4) SA 60 (W) at para 43 in the context of a confiscation order, "This is a principle well-known to our common law, which has spawned a variety of rules such as those expressed by the maxims *nemo ex suo delicto meliorem suam condictionen facere potest*, *ex turpi causa non oritur actio, in pari delicto potior est condictio defendentis* and de bloedige hand neemt geen erffenis."

[25] *Jajbhay v Cassiem* 1939 AD 437 at 544, 545.

The relaxation of the *par delictum* rule was considered in *Afrisure CC and Another v Watson NO and Another* [26] and where full performance had taken place and both parties were acted with turpitude. The public interest considerations were sufficient to recognise the claim where the statutory provisions that had been contravened by the payments were aimed at the protection of the third party members of the medical scheme.

> "*No definite criteria have, however, been laid down to decide whether the rule should be relaxed or not. The reason, I think, is plain. The issue of relaxation may arise in such an infinite variety of circumstances that it would be unwise for the courts to shackle their own discretion by predetermined rules or even guidelines as to when relaxation of the par delictum rule will be allowed*."[27]

The same approach to determine the scope and content of the just and equitable order under section 89(5) would be appropriate. Of course, the order will have to rationally link to the declaration of unlawfulness and the consequences of the void credit agreement. To determine what is "just and equitable" under section 89(5), and whether the *par delictum* rule may be relaxed, must be determined on the wide variety of possible relevant facts, with reference to the context and purposes of the Act, such elements of public policy that are relevant, and of course whether such determination is consistent with the Constitution. The court will consider each case on its merits in order to achieve a just and equitable result. [28]

8. Other unlawful credit agreements or prohibitions under the Act

The National Credit contains several other prohibitions against the conclusion of credit agreements. In some instances, it provides for a sanctions or remedy depending on the contravention, while in other instances, the Act is silent.

[26] *supra*.

[27] *Afrisure CC and Another v Watson NO and Another supra* at para 39.

[28] *South African Forestry Co Ltd v York Timbers Ltd* 2003 (1) SA 331 (SCA) at paragraph [14]. With the view to determine how best the values of the Constitution can be promoted by an order that is just and equitable, a casuistic approach on the facts is followed: *Minister of Home Affairs and Another v Fourie and Another* (2006 (1) SA 524 (CC) at para [135]

A credit provider that only enters into credit agreements exempted from the operation of the NCA need not register as section 89(2) does not apply.[29]

The other prohibitions in the Act are wide ranging.[30] The Act variously prohibits the inclusion of certain terms in credit agreements,[31] or the conclusion of credit agreements unless certain requiring pre-agreement processes and disclosures are complied with and specifies terms to be included in the credit agreement.[32]

Reckless credit

Despite the express prohibitions in respect of reckless credit that "A credit provider must not enter into a credit agreement without first taking reasonable steps to conduct and affordability assessment and must not enter into a reckless credit agreement",[33] the Act does not require declaring the reckless credit agreement to be unlawful and void. Instead the court or tribunal declaring an agreement reckless is directed to (a) set aside all or part of the consumer's rights and obligations under that agreement, as the is determined just and reasonable in the circumstances, or (b) suspend the force and effect of that credit agreement, (c) determine the over-indebtedness of the consumer and (d) restructure the consumer's obligations under any other credit agreements, in accordance with section 87.[34]

The consequences of the breach of the prohibited conclusion of a "reckless" credit agreement does not result in the credit agreement being rendered void, but it may have that result if the all obligations are set aside,[35] in an order that is "just and reasonable in the circumstances". If not all obligations are set aside, the agreement

[29] *Paulsen and Another v Slip Knot Investments 777 (Pty) Ltd* Case CCT 61/14 [2015] ZACC 5 para [38] to [41]; *Paulsen and Another v Slip Knot Investments 777 (Pty) Ltd* 2014 (4) SA 253 (SCA) at paragraphs [6] and [13] at 256H – J and 258H – 259A.

[30] Often the expression "must not" is utilised.

[31] These are rendered unlawful under section 90(2)(a) to (o). The relevant term is void from the date that it is "purported" to take effect under section 90(3). Section 91(a) prohibits unlawful terms in a supplementary document or agreement.

[32] Sections 92 and 93 - a credit provider must not enter into a credit agreement unless the required pre-agreement statement and quotation in the prescribed form was provided to the consumer and under section 93 read regulation 31 and 32, the credit agreement itself must comply with requirements with regard form, information and content.

[33] Reckless credit - Section 81(2)(a), (b) and (3).

[34] Section 83, as amended.

[35] Section 83(2)(a).

remains enforceable, despite the conclusion of the credit agreement against the express prohibition in section 82(1) (the "credit provider must not enter into a credit agreement without first taking reasonable steps to conduct and affordability assessment").

Unlawful provisions

Similarly in relation to a prohibited term that is unlawful, such unlawful provision is void as from the date that the provision takes effect.[36] The court must sever the unlawful provision from the agreement; or alter it to render it lawful if reasonable to do so (having regard to the agreement as a whole); or; further alternatively, declare the entire agreement unlawful.[37]

After declaring the credit agreement unlawful due the failure based on the inclusion of unlawful terms, the court must thereafter under section 90(4) *"make any further order that is just and reasonable in the circumstances to give effect to the principles of section 89 (5) with respect to that unlawful provision, or entire agreement, as the case may be*".

The correlation between sections 83(2)(a), 90(4) and 89(5) is evident: the same considerations as to the restoration of performances under an enrichment action under section 89(5) and the exercise of a discretion to make a just (and reasonable or equitable) order, as the case may be, will probably arise in the context of both sections 83(2)(a) and 90(4).

Given these varying sanctions for various transgressions of the prohibitions under the Act, the overall consideration that may be distilled is that the law, with the purposes of the Act in mind and the mischief that it addresses, must interpreted to seek a fair, just and equitable resolution where tension arises between the conflicting interests that are regulated under the Act.

What is just and equitable, and when, or whether the *par delictum* rule will be relaxed, will be strongly dependant on the peculiar facts of the matter for determination. Although such approach, which accords with the *Afrisure* dictum above,[38] may seem to create uncertainty through a casuistic approach, the

[36] In terms of section 90(2)(a) to (o).

[37] See section 90(3) read with (4)(a) and (b).

[38] supra "…that it would be unwise for the courts to shackle their own discretion by predetermined rules or even guidelines as to when relaxation of the par delictum rule will be allowed".

determination will be informed by the values and norms of the law informed by the values and norms of the Constitution.

9. **Considerations on the recognition of restoration or unjustified enrichment claims under section 89(5)(a)**

It is suggested in the context of the National Credit Act, that the following considerations may be relevant to exercise of the discretion when a "just and equitable order" is required to be made, and including in relation to the determination of a claim based on unjustified enrichment and the application of the *par delictum* rule. The list cannot be exhaustive:

- The scope, nature or extent of the compliance or non-compliance of the credit provider generally. If the credit agreement slipped through the cracks under an otherwise compliant and diligent credit provider, an order for payment of the amount of the unjustified enrichment (or the capital) by consumer, may be just and equitable.
- Where the agreement was unlawful, but induced by the dishonesty, non-disclosure or turpitude of the consumer.
- Whether the consumer was misled and exploited, or whether the consumer benefited from the credit agreement: for example, a sum is lent above the threshold for registration at a beneficial reasonable cost to the consumer, enabling the consumer to settle more expensive debts. Whilst at arm's length, the transaction was concluded to assist the consumer who is no longer over-indebted.
- Despite not being registered, the credit provider performed in all respects within the requirements of the Act otherwise, including on aspects such as affordability assessments and would have been fully complaint, save for the non-registration.
- Where the agreement had been performed in full and the consumer had paid back the full amount with interest and other cost of credit charges, the consumer may be entitled to pursue the claim based on the undue benefit received by the credit provider through a claim for unjustified enrichment (if the consumer was impoverished). Ordinarily, where both where both parties have performed their reciprocal obligations under an illegal contract, "simple justice between man and man will usually dictate that, in order to avoid an undue

benefit to the plaintiff, both parties should retain whatever they received"[39] and no claim would be allowed. However, public policy could require in appropriate circumstances that what was obtained against the prohibition of the law must be returned, if that would be "just and equitable".

- Strict adherence to the requirements of the *condictio ob turpem vel iniustam causam* may be relaxed under a just and equitable order.
- Any undue profit made under an unlawful agreement ought not to be retained in the hands of a party who acted contrary to the law and did so at the expense of the other. The Act does not regulate credit that is provided free of any cost of credit or other charge and if no profit is retained by the credit provider, it be able to reclaim the capital paid over to the enriched defendant.[40]
- Procedural: At the time when an order under subparagraph (a) of section 89(5) is sought, the credit provider may not be ready to pursue a claim based on unjustified enrichment, or the consumer may not be ready or be able to oppose or challenge the claim. In such a case, the court may then be required to make procedural directions as to the filing of papers and the leading of evidence for the determination of such claim. As it is the same court that will issue the order under subparagraph (a) to declare the credit agreement void, the relief under the just and equitable order may have to stand over and be determined separately. These considerations are of relevance to proceedings in a Magistrates' Court where the court incidental jurisdiction is restricted and such directions may have to be derived from section 89(5).
- A bona fide ignorant credit provider who does not provide credit in the ordinary course, ought to succeed on the basis of an enrichment claim, given that performance was without any significant (intentional) turpitude.
- Where a gross injustice or iniquitous result would follow if the performances are not restored, or the amount of enrichment of the consumer is significant and unjustifiable.

10. Conclusion

The amended section 89(5)(a) restores the common law and claims based on unjustified enrichment may be recognised. In its current form, section 89(5) provides

[39] *Afrisure supra* at paragraph 46.

[40] *Parbhoo NO v Spilg* 1990 (2) SA 398 (W) at 408. The undue benefit or profit was the funds of the impoverished used to improve the enriched's property.

scope for the determination of claims on just and equitable grounds, beyond the narrow constraints of the common law *condictio ob turpem vel iniustam causam.*

The common law is no longer excluded, and the harsh effects of the maxim *ex turpi causa non oritur actio* with the compounding *in pari delicto potior conditio possidentis vel defendentis* rule (*par delictum* rule) may now be tempered with an order that is just and equitable.

The court now holds additional equitable jurisdiction, beyond the ambit of the common law under the direction that the court must make an order that is just and equitable.

General update on the law of demand guarantees and letters of credit

Michelle Kelly-Louw[*]
Karl Marxen[**]

1. Introduction

Demand guarantees (independent guarantees), standby letters of credit and commercial letters of credits are all treated as autonomous (independent) contracts whose operation will not be interfered with by courts on grounds immaterial to the guarantee or credit itself. The idea in the documentary credit transaction/demand guarantee transaction is that if the documents presented are in line with the terms of the credit/guarantee the guarantor/issuer (eg bank) has to pay, and if the documents do not correspond to the requirements, the guarantor/issuer must not pay.

However, over the years a limited number of exceptions to the independence (autonomy) principle of demand guarantees and letters of credit have come to be acknowledged and accepted in practice. In certain circumstances, the autonomy of demand guarantees and letters of credit may be ignored by the guarantor/issuer (eg bank) and regard may be had to the terms and conditions of the underlying contract. Established fraud is the only internationally accepted exception to the autonomy principle.[1]

Our update focusses on a few South African cases that were decided during the last year dealing with demand guarantees (independent guarantees). These cases are also important for commercial letters of credit due to the similarity of letters of credit to demand guarantees. We also discuss a German case decided two years ago that has not been discussed before at *ABLU* and of which we are convinced will add some value to the general understanding of demand guarantees in South Africa.

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[1] Enonchong "The autonomy principle of letters of credit: an illegality exception?" (2006) *Lloyd's Maritime and Commercial Law Quarterly* 404 at 405. For a recent discussion of the fraud exception in South Africa and the latest case law, see Kelly-Louw "Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser & Pretorius (eds) *Essays in honour of Frans Malan: former judge of the Supreme Court of Appeal* (2014) at 197–218.

2. South African case law

2.1 State Bank of India v Denel SOC Limited[2]

Court of first instance

Denel Soc Ltd (Seller/Supplier), a South African State Owned Entity and a manufacturer and supplier of defence equipment, entered into a contractual relationship with the Union/Government of India (Purchaser) for the supply of defence equipment and ammunition (underlying contract). The sales contract contained warranty clauses concerning the goods sold and clauses concerning Denel's performance in terms of the contract.

The Union of India required Denel to provide one performance and seven warranty guarantees (first demand guarantees) in respect of the goods that Denel sold. Denel (Applicant of the warranty and performance guarantees), through a South African Bank, ABSA Bank Ltd, requested two banks in India, the State Bank of India and the Bank of Baroda, to provide the warranty and performance guarantees, respectively. The seven warranty guarantees called for a written demand stating that the seller (Denel) had **"not performed according to the warranty obligations"** for the goods delivered under the said contract. The performance guarantee called for a written demand stating that "**the goods have not been supplied according to the contractual obligations**" under the said contract. In each of the eight guarantees it was recorded that the Union of India's written demand would be conclusive evidence that such payment was due, which payment would be effected upon receipt of such written demand. These were the principal guarantees between the two parties to the underlying contract (ie, Denel and the Union of India) and they were governed by the laws of India. The two banks of India also required guarantees that Denel (Applicant of the principal guarantees) would pay them if and when they discharged their obligations under the principal guarantees (ie, warranty and performance guarantees) to the Union of India (Beneficiary of the principal guarantees). Therefore, Denel (applicant of the counter-guarantees) requested the South African bank, ABSA Bank Ltd to provide the Indian Banks with eight different counter-guarantees amounting to about USD 5 582 714,00).

The counter-guarantees were first demand guarantees/independent guarantees. In terms of the counter-guarantees, ABSA Bank (Guarantor) could draw upon Denel's bank account all the payment that it (ABSA Bank) had made in the discharge of its obligations

[2] (947/13) [2014] ZASCA 212 (3 December 2014).

under the counter-guarantees. The counter-guarantees provided that ABSA Bank would pay the Indian Banks on first written demand **stating that they have been called upon to make payment under and in terms of the principal guarantees** (ie, performance and warranty guarantees). It should be pointed out that initially (when the matter served before the court of first instance) it seemed that all the counter-guarantees were governed by the South African law (they were all silent as to any governing ICC rules). It was only later, when the matter was heard by the South African Supreme Court of Appeal (discussed below) that it transpired that one of the counter-guarantees was, in reality, subject to the laws of India.

During the course of the contractual relationship between the Union of India and Denel, the Union of India alleged that Denel had breached its contractual obligations and called upon the Indian Banks to pay in terms of the principal guarantees. The Indian Banks (Beneficiaries of the counter-guarantees) duly complied and in turn called upon ABSA Bank to pay the corresponding amounts due in terms of the counter-guarantees. The Union of India stated in their written demands made on the Indian Banks that “the seller has not performed according to the contractual obligations for the goods delivered”. At first, ABSA Bank refused to pay contending that the demand made in terms of the counter-guarantees “were not worded under and in terms of the guarantees issued”. Later on, ABSA Bank changed its mind and on 25 May 2011 it advised Denel of its intent to make payment at 12:00 on 26 May 2011 in respect of the counter-guarantees in the amount of USD 3 776 197. Denel disputed that Union of India was entitled to make a demand on the principal guarantees and maintained that ABSA Bank was accordingly not lawfully bound to honour the counter-guarantees. On 26 May 2011, Denel obtained an urgent interim interdict (injunction) on an ex parte basis against ABSA Bank restraining the Bank from making payment to the two Indian Banks in respect of the counter-guarantees that ABSA Bank had issued pending the finalisation of this application before the court.

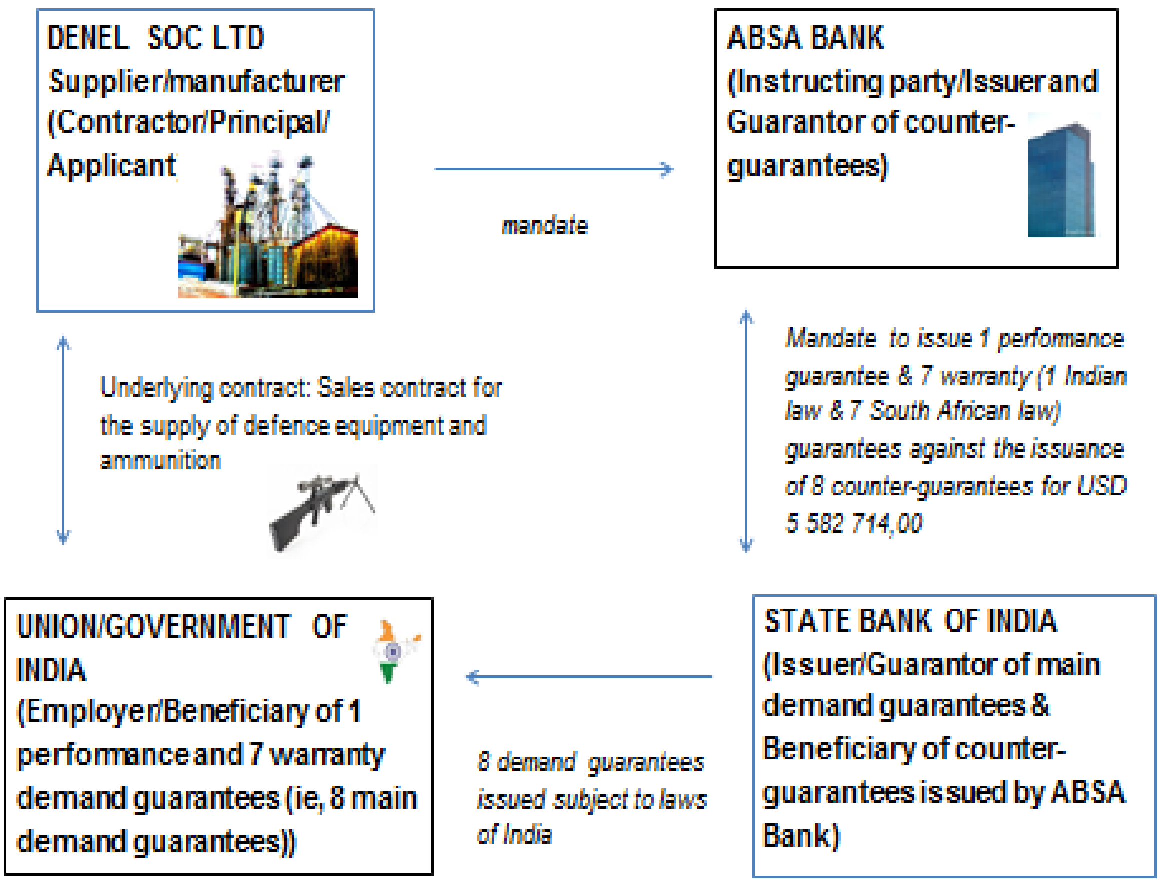
Denel had applied specifically for an order interdicting ABSA Bank from making payment to the Indian Banks in respect of the counter-guarantees pending the finalisation of arbitration proceedings, already instituted and pending in India, in respect of the principal guarantees. Denel also sought interdictory relief in India to restrain the Union of India (Beneficiary of principal guarantees) from calling up or making demands in respect of the principal guarantees pending resolution of a dispute that had arisen between Denel and the Union of India (ie, parties to the underlying contract (sales contract)) in arbitration proceedings in India. The two Indian Banks were also parties to the proceedings in India.

The application for confirming the interim interdict concerning the counter-guarantees was heard by the South Gauteng High Court, Johannesburg (ie, court of first instance). Denel based its application mainly on the two following grounds:

- The demands made by the Union of India (Beneficiary of principal guarantees) against the two Indian Banks in terms of the principal guarantees were not strictly compliant and in turn the demands made by the two Indian Banks against ABSA Bank (Guarantor of counter-guarantee) in terms of the counter-guarantees, which were identical to the first mentioned demands, were similarly not strictly compliant.
- The Union of India's demands in respect of the principal guarantees were fraudulent and therefore the Indian Banks' demands in respect of the counter-guarantees were similarly fraudulent since they were made with full knowledge of the fraudulent demands in respect of the principal guarantees.

Schematically, the position can be rendered as follows:

<u>State Bank of India v Denel SOC Limited</u>



Denel's case was thus based on non-compliance and fraud. Denel argued that because the question whether the Union of India made fraudulent demands on the principal guarantees had been referred to arbitration in India, it would be desirable and practical that the question of fraud be resolved before the counter-guarantees were called up.

The two Indian Banks resisted the application on various grounds. First, as the counter-guarantee was independent from the principal guarantees, it was therefore independent from any dispute that might arise from the underlying contract (contract of sale) between Denel and the Union of India. Second, although established fraud on the part of the beneficiary was an exception to the principle that the demand guarantee was payable on the presentation of a demand regardless of whether the obligations in the underlying contract have been performed or not, Denel has failed to establish fraud on either ABSA Bank's part or on the part of the two Indian Banks. Thirdly, the demands made by the Union of India on the principal guarantees were compliant. Lastly, ABSA Bank and Denel have waived their rights to refuse to honour the counter-guarantees because of alleged non-conforming demands for payment by the Union of India.

The court of first instance (per Malindi AJ)[3] relying on various authorities, acknowledged that the principal guarantees and the counter-guarantees involved in the case before it constituted independent guarantees that were not only independent from each other, but also from the underlying contract (contract of sale) in terms of which the principal guarantees were issued. The court agreed that as long as the beneficiary of the counter-guarantee's demand under the counter-guarantee complied with the requirements of the counter-guarantee, the beneficiary would be entitled to payment (in the absence of established fraud or another ground for non-payment), whether or not the beneficiary of the counter-guarantee has, in fact, paid the beneficiary of the primary guarantees or has received a demand for payment on the primary guarantee or was legally liable to pay a demand received on the primary guarantee.

The court of first instance also acknowledged the documentary nature of the principal guarantees and the counter-guarantees. In deciding whether compliant demands were made on the counter-guarantees, the court referred to Bertrams's[4] opinion that the doctrine of strict compliance applied only to letters of credit and substantial compliance applied to the demands made under demand guarantees. The court then referred to *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd*[5] where it was implied by the South African Supreme Court of Appeal that the principle of strict compliance was applicable to commercial letters of credit. It also pointed out that in *Compass Insurance Co Ltd v Hospitality Hotel Developments (Pty) Ltd*[6] the South African Supreme Court of Appeal did not express its

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[3] *Denel Soc Limited v ABSA Bank Limited and Others* [2013] 3 All SA 81 (GSJ).

[4] See Bertrams *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* 3 ed (2004) at 140–143.

[5] 2002 (3) SA 688 (SCA).

[6] 2012 (2) SA 537 (SCA).

opinion as to whether “strict compliance” was, in fact, necessary for demand guarantees. Reference was also made to Kelly-Louw’s view that strict compliance should also apply to demand guarantees.[7]

The court of first instance stated that the principal and counter-guarantees in the matter before it were restricted to payment upon the occurrence of an event, which was “**that the seller has not performed according to the warranty obligations**” or that the Indian Banks have been called upon “to make payment under and in terms of [their] guarantee”, respectively. Neither the principal guarantors (ie, two Indian Banks) nor the guarantor (ABSA Bank) of the counter-guarantees were obliged to pay for non-performance “**according to their contractual obligations**”. Therefore, the guarantors’ (Indian Banks’) of the primary guarantee were obliged to make payment upon the condition that Denel (Applicant) has not performed according to the warranty obligations or has defaulted under and in terms of its warranty obligations. They were not obliged to pay the Union of India (Beneficiary of principal guarantee) on the basis that Denel had not performed according to the contractual obligations nor was ABSA Bank (Guarantor of the counter-guarantees) obliged to pay the Indian Banks (Beneficiaries of the counter-guarantees) upon this premise. Therefore, the guarantors were only obliged to pay in terms of the promise made under the warranty obligations.

The court of first instance also referred to the English case of *Frans Maas (UK) Ltd v Habib Bank AG Zurich*[8] where it was stated that if the demand called for the term “failure to pay” it would not suffice if the demand made read “failure to meet contractual obligations”:

> “A failure to ‘meet a contractual obligation’ is far from being the same as ‘failure to pay under a contractual obligation’. In effect, the former concept is wide enough to cover any claim for damages for unliquidated or unascertained sums arising from any breach . . . which would seem . . . to widen the scope of the guarantee far beyond that which the parties intended.”

The court therefore made the point that a failure to meet a contractual obligation was far from being the same as a failure to meet a warranty or guarantee obligation.

The court acknowledged that demand guarantees had to be paid according to its terms, without proof or condition, except if clear fraud was involved of which the guarantor had knowledge. A beneficiary had to meet the conditions set out in the guarantee if it wanted to be successful with its claim. Therefore, whether demand conformed strictly to the requirements of the guarantee or to the principle of strict compliance was a matter of a proper interpretation of the guarantee itself.

[7] See Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees: The Main Exceptions to the Autonomy Principle* (2009) (VDM Verlag: Germany) at 89–91.

[8] [2001] Lloyd’s Rep Bank 14 in par 62.

The court of first instance concluded that the demands made by the Indian Banks in terms of the counter guarantees on ABSA Bank did not comply because they were made for a purpose that was too wide than the parties had agreed to – that the Indian Banks would pay the Union of India (Beneficiary of the principal guarantee) in the event that Denel (Seller/Applicant) failed to meet its performance and warranty guarantees in terms of the contract of sale (underlying contract related to the principal guarantees) and that the Indian Banks' demands on ABSA Bank would similarly be restricted to those purposes. The court also added the following:[9]

> "[T]he guarantees were only for the purposes pertaining to clauses 9 (warranty guarantee) and 12 (performance guarantee) of the agreement. This factor is also one of simply no compliance and therefore does not require any examination as to whether it meets the standard of 'strict compliance' or 'substantial compliance'. Both the principal and counter-guarantees were called for the reasons which were not promised by the Applicant [ie, Denel]."

The court of first instance was of the opinion that it did not have to determine whether Denel had established fraud against the Union of India of which the Indian Banks had notice of, because that issue was before the courts and the arbitration proceedings in India. Accordingly, the court of first instance confirmed the interdict requested. It effectively interdicted ABSA Bank from making payment in respect of the counter-guarantees, pending the final determination of arbitration and court proceedings in India concerning the principal guarantees.

South African Supreme Court of Appeal

The two Indian Banks appealed against the whole ruling of the court of first instance and the matter came before the South African Supreme Court of Appeal.[10] The main question the South African Supreme Court of Appeal had to answer was whether Denel (First respondent in this case) was entitled to an interdict (injunction) prohibiting ABSA Bank (Second respondent in this case) from paying out in terms of the eight counter-guarantees that the Bank had issued in favour of the two Indian Banks (Appellants in this case).

The parties agreed with the legal principles that applied to demand guarantees and counter-guarantees, but differed on the application of these principles to the "peculiar" facts of the case.[11]

The Supreme Court of Appeal (per Fourie AJA with Brand, Bosielo, Theron and Mbha JJA concurring) agreed with the court of first instance's view regarding the independent nature of the eight principal guarantees and the counter-guarantees. It

[9] *Denel Soc Limited v ABSA Bank Limited and Others* [2013] 3 All SA 81 (GSJ) in par 55.

[10] (947/13) [2014] ZASCA 212 (3 December 2014).

[11] In par 6.

specifically acknowledged the independence of the principal guarantees and the counter-guarantees from the underlying contract between Denel and the Union of India. It also confirmed the independence of the counter-guarantees from the principal guarantees.

The Supreme Court of Appeal acknowledged that demand guarantees were documentary in character. It agreed with the court of first instance's view that as long as the beneficiary of the counter-guarantee's demand under the counter-guarantee complied with the requirements of the counter-guarantee, the beneficiary would be entitled to payment whether or not the beneficiary of the counter-guarantee has, in fact, paid the beneficiary of the primary guarantees or has received a demand for payment on the primary guarantee or was legally liable to pay a demand received on the primary guarantee. All that was required for payment was, therefore, a demand by the beneficiary, stated to be on the basis of the event specified in the guarantee. Whether or not the demand was compliant would turn on an interpretation of the guarantee.[12]

The Supreme Court of Appeal confirmed that the only exception to the rule that the guarantor was "bound to pay without demur, is where fraud on the part of the beneficiary has been established".[13]

Next the Supreme Court of Appeal considered whether the demands made by the Union of India for payment in terms of the respective principal guarantees, complied with the terms of the relevant guarantees. It pointed out that in each of the seven principal warranty guarantees the written demand made by the Union of India was basically similarly worded, namely, that, as the goods have not been supplied by Denel in accordance with the "**contractual obligations**" payment in terms of the principal guarantees was demanded. The Supreme Court of Appeal held that it was immediately clear that these demands differed from the wording of the seven principal guarantees which prescribed a demand that Denel had not performed according to the "**warranty obligations**" under the underlying contract.[14]

Thereafter, the Supreme Court of Appeal said it was necessary to inquire whether the Indian Banks have addressed written demands to ABSA Bank regarding the counter-guarantees stating that they have been called upon to make payment under and in terms of their corresponding principal warranty guarantees. It said if that was so, then ABSA Bank would be obliged to honour the counter-guarantees without demur, but if not, it would not be liable to make any payment in respect of such guarantees.[15]

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[12] In par 9.

[13] In par 10.

[14] In par 13.

[15] In par 14.

The Court found that in six of the principal warranty guarantees and the corresponding warranty counter-guarantees, the demand was expressly premised on a failure by Denel to comply with its "contractual obligations" and not a failure to comply according to the "warranty obligations" under the contract. Therefore, in these six instances the Indian Bank had not complied with the terms of the counter-guarantees. Accordingly ABSA Bank was not obliged to make payment to the Indian Banks under such circumstances.[16]

The Court then proceeded to deal with the seventh warranty counter-guarantee. The Court pointed out that although the counter-guarantee had the same wording as the other six warranty counter-guarantees, it had an additional paragraph that provided "[t]his counter guarantee shall be governed by and construed in accordance with the Indian laws and is subject to the exclusive jurisdiction of courts in India". The Indian Banks argued that the effect of this clause was to oust the jurisdiction of the South African courts in regard to this specific counter-guarantee. Therefore, the court of first instance should not have interdicted payment on that counter-guarantee. The Supreme Court of Appeal stressed that this defence was not foreshadowed in the Indian Banks' papers in the court of first instance nor was it raised in their application for leave to appeal.[17]

In dealing with the Indian Banks' submission, the Supreme Court of Appeal stated that it had to be borne in mind that there was a banker-client relationship between ABSA Bank and Denel. Denel had mandated ABSA Bank to make payment in terms of the warranty counter-guarantees and it had to be accepted that Denel was aware of the terms of the counter-guarantees, including this seventh guarantee. It thus follows that if a dispute were to arise regarding this seventh counter-guarantee, Denel would be aware that it would have to be interpreted in accordance with Indian law and be subject to the exclusive jurisdiction of the Indian courts.[18] The Supreme Court of Appeal held that the court of first instance did not have the jurisdiction to issue the interdict (injunction) in this instance.

Lastly, the Court considered the demand made by the Union of India under the principal performance guarantee issued by one of the Indian Banks, namely State Bank of India and totalling USD 1 197 930,00. As, mentioned above, the demand called for a written demand stating that the goods supplied by Denel were not in accordance with the "contractual obligations". The corresponding counter-guarantee issued by ABSA Bank called for a written demand stating that State Bank of India had been called upon to make payment under and in terms of their principal performance guarantee. The actual demand made by

[16] In par 17.

[17] In par 19.

[18] In par 21.

State Bank of India simply stated that a demand had been made to pay the principal performance guarantee "for non-fulfilment of contractual obligations". Again the Supreme Court of Appeal reached the conclusion that this was not a compliant demand and ABSA Bank was not liable to make payment under the performance counter-guarantee.[19]

The Supreme Court of Appeal held that, except for the matter involving the seventh warranty counter-guarantee where the South African courts had no jurisdiction, the court of first instance was correct to have interdicted ABSA Bank from paying under the counter-guarantees.[20] In relation to the costs of the appeal the Court pointed out that although the Indian Banks were successful on appeal in respect of one particular counter-guarantee, the jurisdictional defence upon which it succeeded was only raised on appeal. Therefore, parties had to bear their own costs on the appeal.

The Supreme Court of Appeal agreed with the court of first instance that it was not necessary, while the matter regarding the principal guarantees was still pending in India, to deal with the allegations that the Indian Banks had acted fraudulently.

A few comments

In the court of first instance, it was contended that the doctrine of strict compliance applied only to letters of credit and that a less strict standard was applicable to demand guarantees. In South Africa it is still uncertain what the required standard of compliance is regarding documents that are presented in terms of a commercial letter of credit. It has been implied indirectly in various judgments, including those by the South African Supreme Court of Appeal, that the principle of strict compliance is applicable to commercial letters of credit. However, regarding demand guarantees, it is still uncertain as to whether the principle of strict compliance also applies to demand guarantees. Although the court of first instance in *Denel* referred to Kelly-Louw's opinion that the principle of strict compliance should also apply to demand guarantees, it is unfortunate that the court did not express any views on the topic. It is regretted that the Supreme Court of Appeal in *Denel* also did not seize this opportunity to address this important issue. Although both courts in *Denel* did not specifically state that the principle of "strict compliance" was applicable to demand guarantees, it does seem based on the facts of this matter that this was, in fact, the standard that the courts had applied when they had found that the various demands were not compliant. We are of the opinion that the same strict standard of compliance should apply to commercial letters of

[19] In pars 23–25.

[20] In par 26.

credit as well to demand guarantees. Hugo supports this view.[21] The English case of *Frans Maas (UK) Ltd v Habib Bank AG Zurich*, of course, played a pivotal role in the decisions being reached by both courts in the *Denel* case.

The first principle of compliance with regard to demand guarantees is that documents are examined 'on their face' or by their appearance – and *not with regard to the accuracy or truth of the representations that they contain, unless fraud is proven*.[22] In the *Denel* case both courts, in our view, relied too much on the accuracy or truth of the representations that were made by the two Indian Banks in their demands under the counter-guarantees. Although both courts in *Denel* specifically and theoretically acknowledged the independence of counter-guarantees from the primary demand guarantees, they practically lost sight of this principle when they considered the facts of the case. The courts should not have considered whether the demands made under the primary demand guarantees were compliant and valid, because of the independent nature of the counter-guarantees. In determining if the demands under the primary guarantees were compliant, the courts completely ignored the autonomy of the counter-guarantees. The courts should only have considered the actual demands that were made under the counter-guarantees. To determine if the demands made under the counter-guarantees were valid and compliant, the courts should simply have considered what the counter-guarantees had called for regarding the demands and compared them against the actual demands that were made by the two Indian Banks. From the facts in *Denel* it is not absolutely clear exactly what the demands made by the Indian Banks under the counter-guarantees stated. It seems, however, that the demands by the Indian Banks were supposed to explicitly state that they (*ie* Indian Banks) *have been called upon to make payment under and in terms of either their corresponding primary warranty guarantees* or *principal performance guarantee.* However, based on the facts given, it seems that the actual demands made by the Indian Banks all simply stated either that *a demand had been made to pay either the primary warranty guarantees or the primary performance guarantee 'for non-fulfilment of contractual obligations'*.

It is evident that none of the actual demands made under the respective counter-guarantees complied with what was provided for in the terms of the counter-guarantees. The wording used by the Indian Banks in their actual demands did not correspond with the wording required in the terms of the counter-guarantees and were therefore not valid or compliant. If just that fact is taken into consideration and the doctrine of strict compliance is applied to the case it is obvious that the demands made by the Indian Banks were not

[21] Hugo "Protecting the lifeblood of commerce: a critical assessment of recent judgments of the South African Supreme Court of Appeal relating to demand guarantees" (2014) *TSAR* 661 at 662.

[22] Byrne *Standby & demand guarantee practice: understanding UCP600, ISP98 & URDG 758* (2014) at 122.

compliant or valid. This alone should have been enough for the courts in *Denel* to hold that ABSA Bank was not obliged to pay[23] and that it was appropriate to grant the interdict prohibiting payment. Therefore, although the end result would be the same if the courts simply did this, it was completely unnecessary for the courts to look at facts beyond the counter-guarantees and the demands made under them. The courts, however, by also looking at whether valid demands were made under the primary demand guarantees, in reality completely ignored the independence of the counter-guarantees from the primary guarantees. This meant that the courts took into consideration facts well beyond the terms of the counter-guarantees. For example, the courts considered the relationship between the Union of India (beneficiary of the primary guarantees) and the two Indian Banks (guarantors of the primary demand guarantees). Whether the demands in terms of the primary demand guarantees were valid or not is an issue that should be addressed by the Indian courts and during the pending arbitration proceedings in India, especially because the primary demand guarantees are governed by Indian law. Based on the independent nature of a counter-guarantee, the issue of whether a valid demand was made under a primary guarantee, is not at all relevant when a determination needs to be made of whether the demand made under a counter-guarantee is compliant and valid, unless, of course, the terms of the counter-guarantee specifically provides for that. Given the facts in the *Denel* case it is our opinion that the counter-guarantees did not call for that. Although we do not agree with how the courts *Denel* arrived at their decisions, we do agree with the end result, namely to have allowed the interdict.

It is, however, mind boggling how the issue of jurisdiction of the one counter-guarantee in *Denel* could only have been raised during the appeal.

2.2 Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture[24]

Facts

Sulzer Pumps (South Africa) (Proprietary) Limited (Applicant/Contractor/Principal of performance (demand) guarantee) applied, on an urgent basis, for an interim interdict (injunction), which was granted. The interim interdict prohibited Covec-MC Joint Venture (Employer/Beneficiary of performance guarantee/Respondent) to demand payment from the guarantor (Nedbank Limited) of the performance guarantee (demand guarantee). When the

[23] For more on a guarantor’s right not to pay if it receives a non-compliant demand and whether South Africa acknowledges non-compliance as a proper defence for non-payment, see Kelly-Louw “The documentary nature of demand guarantees and the doctrine of strict compliance” (Part 2) (2009) 21 *SA Merc LJ* 470 at 481–484.

[24] (1672/2013) [2014] ZAGPPHC 695 (2 September 2014).

interim interdict was granted, the Beneficiary had already called on Nedbank to make the payment, but the interim interdict prevented the payment from being made. On the return date the matter came before the court (Jansen J) to determine whether the interdict should be made final. The initial application was done on an urgent basis as it was thought, at that stage, that the guarantee would expire in February 2013, but it later transpired that it would actually only expire on 28 February 2015.

The Beneficiary had contracted with Sulzer to perform certain construction work (ie, the Vaal River Eastern Subsystem Augmentation Project). Sulzer provided the Beneficiary with a performance guarantee (silent as to the amount and any governing ICC rules) issued by Nedbank Ltd (guarantor) in respect of the construction contract (underlying contract).

The performance guarantee contained the following clause:

> "3. Payment shall be made to the Employer on receipt by the Bank, at the Bank's domicilium citandi et executandi of the Employer's first written demand and which written demand shall be accompanied by this original guarantee as well as the following:
>
> 3.1 Written confirmation, signed by the employer, stating that the Contractor is in breach of any contract in terms of which this guarantee was required, or that any event triggering payment in terms of this guarantee has occurred".

During the course of the dealings between the parties various disputes arose regarding an alleged breach of the construction contract by Sulzer. Sulzer claimed ZAR 45 million from the Beneficiary, who in turn, counterclaimed for ZAR178 504 073,16. The parties proceeded with arbitration proceedings regarding the breach of the contract. According to Sulzer the parties had reached an agreement on 29 November 2010 that the performance agreement would not be called upon until the arbitration proceedings were finalised, provided that the guarantee was annually renewed and remained valid until such time as the arbitration proceedings (disputes) were finalised. The Beneficiary denied the existence of such an agreement saying that it had simply indulged Sulzer's request not to call upon the guarantee in an attempt to try and resolve the matter, but that it had never agreed to waive its right to demand payment at any time. However, in a letter dated 12 November 2010 the Beneficiary's attorneys sent to Nedbank (guarantor) the following was stated:

> "3.1 we have . . . requested Sulzer's legal representatives . . . on 12 November 2010 to extend the current expiry date of 28 February 2011 of the guarantee to expire only upon the final determination of the disputes between C-MC [Beneficiary] and Sulzer;
> 3.2 we are currently awaiting a response . . . to our attached letter of 12 November 2010 . . .
> 3.3 in the event that Sulzer does not agree to extend the expiry date as indicated in 3.1 above and deliver the original amendment of the guarantee to our offices by no later than . . . Friday 3 December 2010, C-MC shall proceed to demand payment of the guaranteed amount in respect of the guarantee from your offices."

Sulzer's attorneys responded in writing on 25 November 2010 and confirmed that the guarantee would be extended as was requested, but pointed out that Nedbank refused to extend the guarantee for an indefinite period of time and insisted that a date be inserted. They also confirmed that they would supply the Beneficiary with an undertaking that the guarantee would be extended until the final determination of the disputes between the parties.

On 29 November 2010 the bank informed Sulzer as follows:

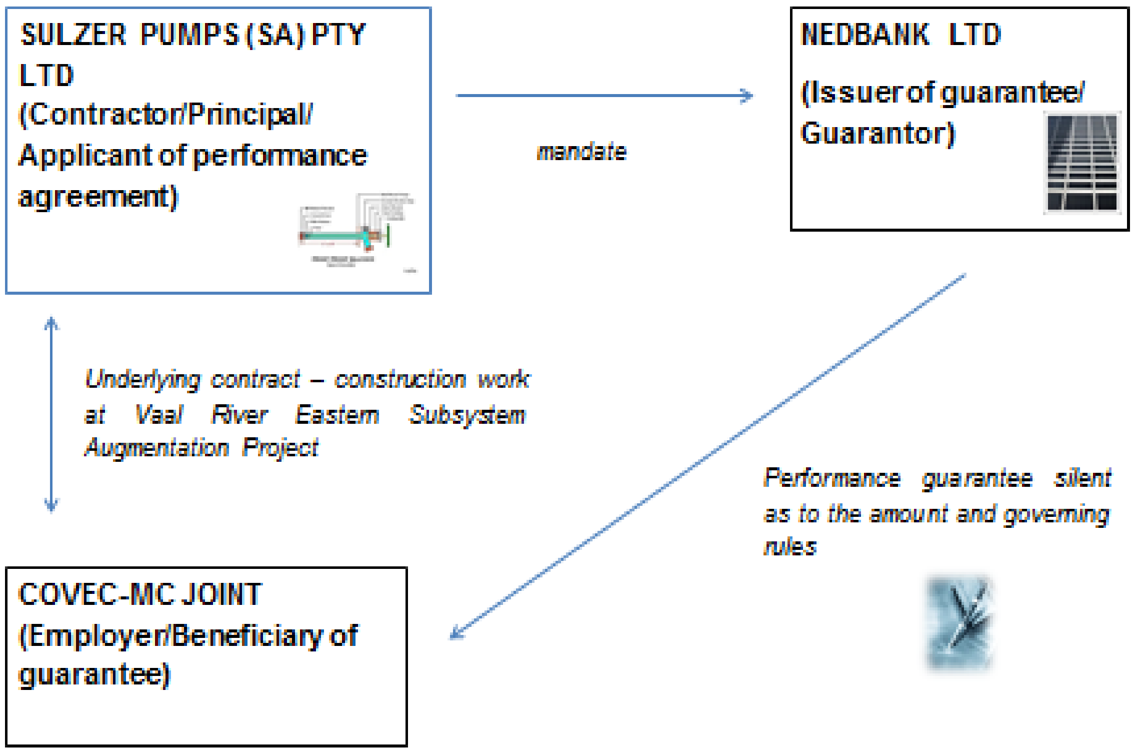
> "1 We refer to the above matter and your attached letter dated 25 November 2010, which we have forwarded to our client for instructions.
> 2. We are instructed that our client is prepared to accept -
> 2.1 the extension of the expiry date of the guarantee to 28 February 2012;
> 2.2 your client's undertaking to further extend the guarantee in the event that the disputes between our respective clients have not been resolved by 28 February 2012,
> on the basis that, in the event that it is anticipated by our client that the disputes between our client and your client will not be determined, to finality, within three months before the expiry date of the guarantee, being by 28 November 2011, that your client will proceed to extend the guarantee, by no later than 28 November 2011, for a further period of 12 months and furnish our client with the original amendment to the guarantee reflecting such further extension.
> 3. In the event that the position referred to in 2 above transpires and your client fails and/or refuses and/or neglects to -
> 3.1 further extend the expiry date of the guarantee, from 28 February 2012 to 28 February 2013, as referred to in 2 above; and
> 3.2 deliver the original amendment to the guarantee, reflecting the requested extension, to our offices by no later than . . . on Monday, 28 November 2011,
> our client shall proceed to demand immediate payment of the guaranteed amount in respect of the guarantee . . .
> 4. The above position regarding the timeframes and the extension will then also apply in respect of the anniversary of the expiry date of the guarantee in the event that the disputes between our respective clients have not been resolved and been finally determined within a period of three months before the further extended expiry date of the guarantee
> 5. Kindly confirm your client's agreement and undertakings in respect of the above process".

Sulzer accepted the undertaking in writing. While the matter between the parties remained unresolved the guarantee was extended on various occasions. It appeared that Sulzer did not adhere to the agreed time frames by which the guarantee had to be renewed, namely, prior to or on 28 November of any particular year. The various renewals and extension letters were done after these dates, but at no time did the guarantee lapse and it was still valid until 28 February 2015. This led to the Beneficiary sending various letters to Sulzer concerning Sulzer's "late" renewal of the guarantee and the submission of the relevant extension letters. The Beneficiary pointed out that although it indulged these "late" renewals and receipt of the extension letters it did not waive its rights to demand payment at any time.

Later, while the arbitration proceedings were still pending, it transpired that a substantial dispute between the Beneficiary and a third party (Trans Caledon Tunnel Authority) had arisen which could substantially affect the construction project and also affect the arbitration dealings between the Beneficiary and Sulzer. As a result, the Beneficiary requested Sulzer for a stay of their arbitration proceedings for two years. Sulzer refused which then prompted the Beneficiary to call up the guarantee. Sulzer immediately brought the application for an interim interdict. The interim interdict was granted and Sulzer proceeded with the subsequent application to confirm the interim interdict.

Schematically, the facts can be rendered as follow:

<u>Sulzer Pumps (South Africa) (Pty) Limited v Covec-MC Joint Venture</u>



Judgment

The court (per Jansen J) considered whether there was in fact an agreement reached between the parties that no demand would be made on the guarantee while the arbitration proceedings were still on-going (ie, until the disputes between the parties were finalised). The court found that the Beneficiary's contention that no such agreement existed was inaccurate on its own version. Jansen J found that it was clear from the correspondence exchanged between the parties that such an agreement had been reached by the parties.

Jansen J confirmed the independence principle of performance guarantees and indorsed the view that courts could generally only intervene to prohibit payment from being made in very limited circumstances, for instance, where fraud was involved. She then proceeded to quote from a paper entitled "Calling on a Performance Security: As Good as Cash?" that was presented by Michael Whitten (18 June 2012) to the Commercial Bar Association Construction Law Section (The Victorian Bar) where the presenter/author discusses three specific exceptions to the autonomy principle in the Australian law (para 41). Jansen J particularly referred to the part of Whitten's paper where he states that courts will not intervene to prevent a party from calling upon a bank guarantee, except in cases of: (1) fraud; (2) unconscionability which generally involves "taking advantage of a special disadvantage of another"' or "unconscientious reliance on strict legal rights" or "action showing no regard for conscience, or that are irreconcilable with what is right or reasonable (Whitten also referred to what was held in *Olex Focas Pty Ltd v Skodaexport Co Ltd and ACCC v Samton Holdings Pty Ltd*[25] as constituting unconscionability); and (3) breach of a negative stipulation in the underlying contract – where calling on the security would be in breach of an express or implied negative stipulation in the underlying contract. Reference was also made to Whitten's statement that the last listed exception was a common basis for contractors challenging a beneficiary's entitlement to call upon a guarantee. To be successful a contractor needed to prove that there were terms in the contract that restrained the calling of the security. Jansen J, however, pointed out that in the matter before her the agreement not to call upon the guarantee was made separately from the underlying construction contract.

Jansen J stressed that it should be borne in mind that to introduce qualifications on the entitlement of beneficiaries to call up guarantees, will deprive such guarantees of their commercial currency. "As a general rule a court will not prevent a party from calling upon a bank guarantee unless the party calling up the bank guarantee is acting fraudulently or unconscionably or has made a contractual promise not to call upon the guarantee" as was held in *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd*.[26]

In delivering her judgment, Jansen J carefully considered the conduct of the Beneficiary. She spent a lot of time studying the communication between the parties regarding the various renewals of the guarantee. She pointed out that there were clearly contradictions in the letters and other communications between the parties as to what the Beneficiary had agreed to regarding the calling up of the guarantee. However, on the court's interpretation of the documents and court papers it was clear (also the only reasonable interpretation) that the Beneficiary had, in actual fact, agreed not to make a call on the guarantee while the arbitration was pending, provided that the guarantee remained valid. The court said evidence in support of its view was also found in the fact that when Nedbank agreed to renew the guarantee annually itself had expressly stated that should the

[25] (2002) 117 FCR 301.

[26] [2008] FCAFC 136.

beneficiary fail to extend the guarantee it would follow that, then (and clearly only then) the guarantee could be called up.[27]

Jansen J said that given the emphasis on the actual intention of the parties, there was no doubt in her mind that the agreement between the parties was that the building guarantee could only be called up once the disputes between the parties had been resolved by way of the pending arbitration proceedings.[28]

She continued and held:[29]

> "not only fraud may prohibit the calling up of a construction guarantee, but also unconscionable conduct and also when a contract to the contrary has been entered into between the relevant parties (in this instance, including the bank). . . .
> Given the fact that Nedbank . . . was a party to the amended construction guarantees, it is bound by these terms. These terms include the extension of the construction guarantees until the issues have been finally determined by arbitration."

Jansen J applied the general principles of the law of contract to interpret the agreement made between the parties regarding the calling up of the guarantee. She also considered the role that "good faith" played in contracts and how that has been applied in the South African case law. She highlighted that the recognition of the principle of good faith, has received very mixed reactions in the South African jurisdiction. She also added:[30]

> "[g]iven the interpretation of the agreement between the parties set out above, it is unnecessary to delve further into the thorny issue of the role of good faith in contracts. However, the court holds that it is clear that when it is unconscionable to rely on the literal wording of a contract without reading such wording within the context of the background facts, the surrounding circumstances and the purpose of the agreement, then a construction guarantee cannot be called up."

The court confirmed the interdict prohibiting the beneficiary from calling up the performance guarantee until the final determination of the pending arbitration proceedings between the parties, except if Sulzer (Applicant) failed to extend the guarantee in accordance with the terms of the performance guarantee in its amended format.

A few comments

This is not a well-reasoned judgment. It is not clear on which exact ground the court confirmed the interdict. The court simply relied on Australian law as the sole authority to say that a beneficiary could be prevented from calling upon a guarantee where he was acting fraudulently or unconscionably or had made a contractual promise not to call upon the guarantee. There is no indication that the court considered the position as it currently exists

[27] (1672/2013) [2014] ZAGPPHC 695 (2 September 2014) in par 99.

[28] In par 108.

[29] In pars 115 and 116.

[30] In par 125.

under the South African law. From a reading of the judgment it seems that the court was of the view that the conduct by the Beneficiary in *Sulzer* was unconscionable. The court also seemed adamant that if an agreement had been entered into between the relevant parties not to call upon the guarantee (either in terms of the underlying contract or in a separate agreement) the beneficiary could be prevented from making a call. It is unclear which grounds constituted the main reason for the interdict being confirmed. At some point the court even made reference to the role of good faith in contracts which could create the impression that the court was also of the opinion that the Beneficiary lacked good faith (ie, acted in bad faith) when he made the demand on the guarantee. Although acting in bad faith is somewhat similar to acting unconscionable, it is unclear if the court meant for bad faith to constitute an additional exception to the independence principle. The exact reason for ignoring the independence principle of the demand guarantee in this case is therefore quite blurred.

At present, in South Africa only fraud is accepted as an exception to the independence principle.[31] The *Sulzer* case now seems to imply that there are also various other acceptable exceptions. The closest the South African courts came to expressing its view on whether a contractual promise not to call upon/draw on the guarantee/letter of credit could constitute a valid ground for ignoring these instruments' independence from their underlying contracts was in *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd*.[32] In this case the court had simply remarked in passing that, had the beneficiary and the applicant entered into an agreement in terms of which the beneficiary undertook not to draw on the letter of credit and had the beneficiary nevertheless sought to extract payment under the letter of credit, the beneficiary could conceivably have been guilty of fraud. Based on the *Union Carriage* case, it would thus seem that the conduct of the beneficiary in the *Sulzer* case could easily have been classified as fraudulent and could have been slotted under the existing fraud exception rather than being labelled as "unconscionable" and thereby creating a separate ground for justifying non-payment. Until now the "unconscionable" and "bad faith" exceptions have not been dealt with or even raised as a possibility in the South African case law. Such exceptions should in any event not be accepted as they seriously undermine the independence of demand guarantees and letters of credit. They also diminish the usefulness of these instruments.

[31] For a full discussion, see Kelly-Louw ""Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser & Pretorius *Essays in Honour of Frans Malan* (2014) at 197–218.

[32] 1996 CLR 724 (W).

2.3 Group Five Construction (Pty) Limited and others v Member of the Executive Council for Public Transport Roads And Works Gauteng and Others[33]

In *Group Five* the court was concerned with whether or not the beneficiary (governmental department) of a demand guarantee (performance guarantee), had complied with the requirements of the guarantee given by the guarantor, an insurance company, when it made its demand for payment. The demand guarantee provided that the demand for payment had to state that the guarantee was called up because the underlying contract had been cancelled (ie, construction of a hospital) and the demand also had to be accompanied by a notice of cancellation of the underlying contract. From the facts it appears that there was some dispute between the parties as to whether or not the underlying contract was cancelled or not. There were also allegations that the beneficiary knew that the underlying contract was not cancelled and, therefore, it had acted fraudulently in making a demand for payment. It must, however, be pointed out that the facts of the matter are quite confusing and somewhat difficult to follow.

From the facts it appears that there were at least two demands for payment made. The first demand was not compliant where after a "second" demand was also made. It seems that none of the demands contained a copy of the cancellation notice relating to the underlying contract as was required in terms of the guarantee.

The court (per Satchwell J), relying on the *Compass* case[34] as authority, found that because no notice of cancellation was submitted when the second demand for payment was made, there was no compliance with what was clearly required in terms of the guarantee and, therefore, the demand was invalid and unenforceable. Furthermore, the court agreed with the contention that the beneficiary acted fraudulently when it made its demand for payment because it knew that it had not cancelled the underlying contract and could not make a demand. As a result, the beneficiary was not entitled to claim in terms of the guarantee and the guarantor was not obliged to pay in terms of its guarantee. In the court's view there was clearly fraud on the part of the beneficiary and, therefore, the second demand was invalid and unenforceable due to the fraudulent behaviour of the beneficiary.

The court based its decision on fraud on several documents/letters that the beneficiary of the guarantee had sent the contractor (counter party to the underlying contract) in which it seems that the underlying contract was, in fact, as contented not cancelled. In reaching its conclusion of fraud the court also took into consideration various internal memoranda/notes and communications from within the governmental department. The court accepted that the documents/letters correctly reflected the factual position and that

[33] (2009/31971) [2015] ZAGPJHC 55 (13 February 2015).

[34] See note 6 above.

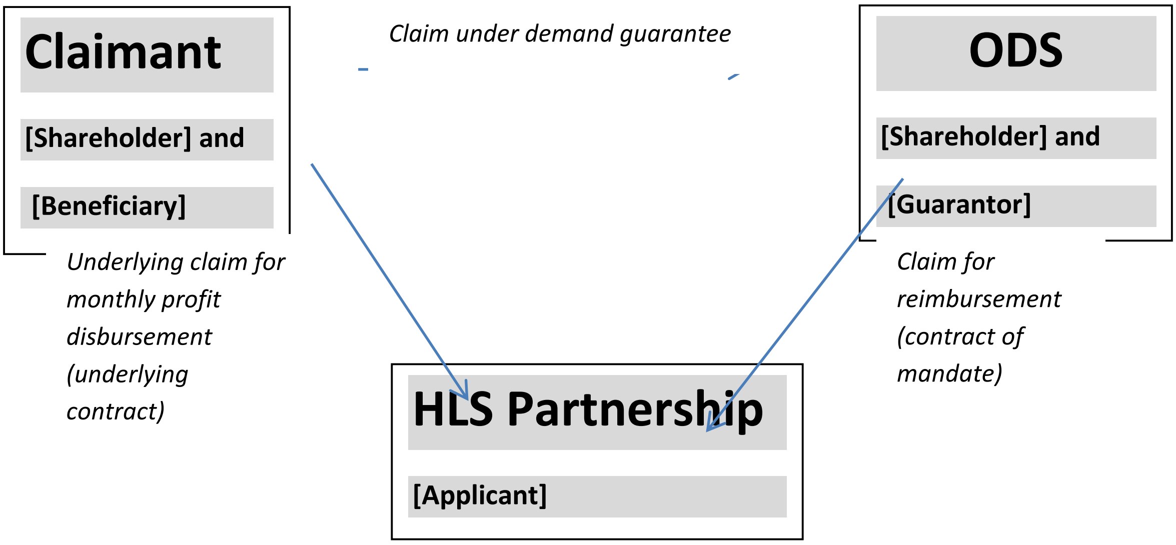
the only possible deduction was that the beneficiary had acted fraudulently. While the facts of this case are indeed very confusing due to the parties' negligent document submission (as Satchwell J remarked in her judgement), we think that she was right in holding that the Gauteng department/beneficiary acted fraudulently when it called up the guarantee. In their internal communications (letters and memoranda) the governmental department seemed to have been fully aware of the fact that the underlying contract was not cancelled, but that it had simply 'expired'. Although Satchwell J was not able to ascertain what the term 'expired' meant as used by the department's internal memoranda and communications, she accepted that the beneficiary was positively aware that the underlying contract had in fact not been cancelled as claimed in the demand. While, in our view, no court should generally investigate the truthfulness of assertions made which accompany demands for payment, we think that the applicant was able to prove convincingly that the Gauteng department knew that no cancellation had taken place. Yet in its demand it still claimed such an event had happened, contrary to its positive knowledge. Apparently, the reason behind the department's reluctance to actually cancel the underlying contract was the fact that the joint venture (and the main contractor, respectively) was a so-called emerging contractor/joint venture, who was supposed to be given an additional chance to complete the works without any penalties, damages, or negative publicity. In conclusion, it is submitted that Satchwell J was right in ruling that the Gauteng department was guilty of fraud, as she showed convincingly in par 41 of the judgement. However, the fact that the second demand made was not a compliant demand was, of course, enough ground for the court to disallow the payment of the demand being made.

The issue of fraud as a defence, nevertheless, calls for some remarks of caution. If there simply is a genuine dispute between the parties to the underlying contract regarding the validity, or cancellation, of the construction contract, a court may not investigate the facts beyond the terms of the guarantee. This is a consequence of the autonomy principle, which must never be disregarded easily. Any beneficiary, acting on an honest and simple misunderstanding regarding the facts (ie the state of the contractual relationship), who proceeds to make an honest claim for payment under the demand guarantee must not been seen as acting fraudulently. The autonomy principle of the demand guarantee also prevents a court from looking at facts beyond the terms of the guarantee, unless it involves a case of established fraud.

3. German case law: *Oberlandesgericht München (7 U 313/12)*

Another interesting demand guarantee case was reported from Germany. Although the judgement was pronounced two years ago, we are convinced that it still adds value to the general understanding of demand guarantees. In *Oberlandesgericht München* (*7 U*

313/12),[35] the court was called upon to decide an appeal stemming from a sophisticated business relationship. Owing to a complex partnership structure, we have simplified certain facts and procedural motions for purposes of this presentation. Schematically, it can be rendered as follows:



In 2006, a limited partnership (*Kommanditgesellschaft*) was founded which, in the court papers, is only identified as *HLS*. The claimant was obliged to deposit the amount of EUR 15 million as share capital, but assumed no further financial obligations or liability on behalf of *HLS*.[36] Another shareholder of *HLS*, referred to as *ODS*, was exempted from putting up share capital, but bound itself to be fully liable for any debts incurred by *HLS*. Under German law, *ODS* entered the partnership as *Komplementär*, a fully liable, general partner. According to the articles of association (*Gesellschaftsvertrag*), the claimant was entitled to receive a lump sum disbursement from *HLS* as profit for its investment in said partnership (the court referred to it as *monatlicher Vorabgewinn*). This monthly claim of EUR 250.000 against *HLS*, however, was underpinned by a demand guarantee issued by *ODS*, the other shareholder.[37] Incidentally, the demand guarantee formed part of the original partnership agreement and was contained in the main agreement. The guarantee stipulated for payment in the event that *HLS* were in arrears for more than five days, "on first demand" and

[35] *OLG München 7 U313/12* (*Urteil vom 13.03.2013*).Traditionally, German cases are only identified by the pronouncing court and the case number. In the course of this case presentation, reference will also be made to *OLG München 7 U 313/12* (*Beschluss vom 05.07.2012*), an order by said court preceding the actual judgement on appeal.

[36] The claimant, therefore, was a *Kommanditist*, a partner with only limited liability.

[37] In par 3 of the judgement (all references in this presentation refer to court documents as reported by *Juris - Das Rechtsportal* database).

irrespective of any defences stemming from the underlying agreement.[38] For several months, the claimant did not receive payment from *HLS*. Subsequently, the shareholder and guarantor, *ODS*, went bankrupt. With reference to the demand guarantee the claimant instituted legal action against *ODS*, or more specifically against the appointed liquidator.[39] It was argued that, although no immediate payment was expected due to the pending insolvency procedure regarding *ODS*, the claim under the guarantee was nonetheless to be formally registered, filed and added to the claims schedule (the *Insolvenztabelle*). It was anticipated that the remaining assets of the insolvency estate would, after consolidation and debt management, suffice for future satisfaction. The liquidator, on behalf of the insolvent *ODS*, contested the notion of an independent guarantee. He submitted, in contrast that the promise was a mere secondary, ancillary undertaking not unlike a traditional surety or conditional guarantee.[40] The facts and arguments, up to this point, do not present us with extraordinary legal issues.

However, in the articles of partnership under which *HLS* was incorporated, the founding partners had agreed on certain provisions in the case of a shareholder going into liquidation.[41] It was stipulated – inter alia – that should a shareholder be placed under liquidation he would be deemed as having lost his position as shareholder with immediate effect.[42] Additionally, should only one shareholder remain after departure of the insolvent former shareholder, the partnership's assets and obligations would automatically transfer onto the remaining shareholder.[43] Therefore, the insolvency of *ODS* triggered its departure from *HLS* and, since only the claimant remained as sole shareholder he immediately assumed both rights and obligations of *HLS*. For purposes of the presentation at hand, we disregard further contentions and developments within the partnership structure,[44] and accept that with *ODS*'s insolvency the assets and obligations indeed vested in the claimant.

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[38] Article 10 (4) of the partnership agreement, see par 3.

[39] The so-called *Insolvenzverwalter*.

[40] Under German law, such an undertaking would be known as a *Bürgschaft* or *bürgschaftsähnliche Verpflichtung*.

[41] See par 7.

[42] Article 15 (2) of the partnership agreement, see par 7 of the judgement.

[43] In par 7.

[44] Compare par 5 et seqq. Essentially, the claimant argued that another juristic person (referred to as *CoFonds* in the court papers) entered the *HLS* partnership prior to *ODS*'s insolvency, and thus prevented the claimant from being the sole remaining shareholder. Eventually, the *Oberlandesgericht München* rejected this contention. For practical reasons we have decided to leave out this – admittedly very interesting aspect – in order to focus on other issues more relevant to the law of demand guarantees.

Also, the legal interplay between insolvency law and statutory requirements regarding undercapitalisation under German company law is left out in this presentation.[45]

Articles of association (*Gesellschaftsvertrag*):
(1) If shareholder insolvent: immediate departure from the partnership **(2) If only one shareholder remaining: automatic transfer of all rights and assumption of all obligations (from partnership onto last remaining shareholder)**

This puts the focus on the central issue, which the *Oberlandesgericht München* had to decide: By way of the partnership agreement, and the operation of the respective provisions therein, the claimant effectively succeeded the partnership (*HLS*). Accordingly, the liquidator for *ODS* raised the defence of *confusio*.[46] On behalf of *ODS* he argued:

(1) that with the concurrence of the outstanding claim for the monthly profit payment in the person of the claimant, this obligation ceased to exist (*confusio*); the claimant therefore lost his right against *HLS* stemming from the underlying partnership agreement.

(2) As a consequence, also the separate claim on the guarantee (which was furnished to secure this very underlying obligation) was also not enforceable anymore.

The court agreed, and allowed the appeal. Although the court ruled that the guarantee was indeed a primary, unconditional undertaking and that the independence principle insulates the claim under such a demand guarantee from the underlying dispute,[47] it was held that the claimant's action constituted an abuse of rights (*Rechtsmissbrauch*).[48] This was based on the notion that with the insolvency of *ODS*, it departed from *HLS* and the only remaining shareholder, the claimant, stepped into *HLS* legal position. The claimant acquired all rights and assumed all outstanding obligations. With reference to the doctrine of *confusio* (*Konfusion*), it was emphasised that the claimant had become both creditor and debtor of the monthly payment obligation. Therefore, the underlying claim was extinct. Further, by way of *confusio*, the claimant had also turned into being the beneficiary and the applicant of the

[45] For this aspect, regard may be had to par 8 et seqq.

[46] *Confusio* is also referred to as *merger* in legal writing, see Scott et al *The law of commerce in South Africa* (2009) 113 in par 6.5; Du Bois et al *Wille's Principles of South African law* (2007) 831 in par 2.

[47] In pars 20-23 and 26.

[48] In par 25 et seqq.

demand guarantee concurrently.[49] This unusual scenario would qualify any demand on the guarantee as an abusive conduct, because the claimant would be obliged to repay any proceeds received under the guarantee immediately to the guarantor, *ODS*.[50] For that reason, the appeal succeeded and it was held that the claimant was not entitled to any payment under the guarantee.

In our opinion, the judgement is correct when examined with a strong focus on the German doctrine of *Rechtsmissbrauch* (abuse of rights).[51] According to this concept, a beneficiary under a letter of credit or a demand guarantee may not claim if his actions would amount to an obvious abuse of rights (*offensichtlicher Missbrauch*). For the case at hand, it is clear that money received by the beneficiary (the claimant) would have to be (re)paid to the guarantor (*ODS*) immediately. This stems from the contract of mandate obliging the applicant to reimburse the guarantor for all (reasonable) expenses incurred. Applying the principle of *confusio*, the claimant was not only the beneficiary to the demand guarantee, but also assumed the role of the applicant. With that in mind, arguably one can see the abusive nature of his insistence on payment under the guarantee. The objection by the liquidator based on the "dolo facit, qui petit, quod statim redditurus est"[52] in conjunction with the general principle of *Rechtsmissbrauch* is, therefore, convincing.

For the understanding of the practical application of demand guarantees and the law relating thereto, we think this decision offers several interesting points for discussion: First of all, it presents an unusual – yet judicially approved – way of issuing a guarantee. While most independent guarantees are issued in a separate document, it shows that this does not necessarily have to be so. The *Oberlandesgericht München* did not object in any way to the form in which the guarantee was furnished, and we see no reason why South African courts would. Irrespective of the particular form in which such an independent promise is given, it follows the same principles of independence and (strict) compliance as would a separately issued demand guarantee.[53] Further, this case proves the point that independent demand

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[49] In pars 25 and 27.

[50] In pars 25, and 27–28. However, compare also the remarks to the contrary in the earlier order (*Gerichtsbeschluss*) by the same court, *OLG München 7 U 313/12* (*Beschluss vom 05.07.2012*) in par 11. In the later judgement, which forms the basis of this presentation, obviously the court reversed its prior findings, see par 25 of the judgement. In any event, the divergent views are probably explained with supplemented evidence and further available proof.

[51] Our assessment only relates to the immediate legal issues as discussed in this presentation. Questions of undercapitalisation, the alleged existence of a further shareholder and the very interesting issue of considerations concerning economic risk distribution are deliberately left unaddressed for purposes of this conference paper.

[52] In par 11 of the preceding court order, *OLG München 7 U 313/12* (*Beschluss vom 05.07.2012)*.

[53] For the interesting question whether the doctrine of strict compliance should govern demand guarantees in South Africa, see above.

guarantees should be named thus; the term *bank guarantee* ought to be avoided in order to minimise the existing confusion around terminology prevalent in this field. Today, there are not only banks that issue such guarantees, but also insurance companies and other financial institutions. Considering the issue of *confusio* in the context of demand guarantees, this is indeed a very unusual case. Although it is unlikely that we will see a similar set of facts before South African courts, one can still derive certain normative ideas from this German case. The view that the beneficiary/applicant, wearing two hats at once, would eventually have to reimburse the guarantor upon receipt of the money is fully in line with South African law. However, the issue of whether to allow cash to exchange hands, albeit temporarily, can be determined with different results, based on notions of public policy. Furthermore, the case could fuel the ongoing debate as to *what* constitutes fraud in relation to the fraud exception to the principle of independence in demand guarantees. This very point has been a contentious and much debated subject across most jurisdictions, and scholarly writing and recent case law have contributed to the still ongoing discussion.

4. Demand guarantees: International efforts of harmonisation

In addition to the South African cases and the German decision, we would like to seize the opportunity and comment briefly on the recent state of international efforts to harmonise the law relating to demand guarantees. The attempts for international legal harmonisation in the field of demand guarantees remain an issue of concern for practitioners and academics; in the past this problem has been addressed several times at this conference.[54] For this year's conference one can only repeat the increasingly familiar observations yet again: While letters of credit are almost inevitably issued subject to the *Uniform Customs and Practice for Documentary Credits (UCP 600)*, regrettably we still cannot report a similar trend for demand guarantees. In recent legal writing, the 2010 *Uniform Rules for Demand Guarantees (URDG 758)* are seen as having gained further acceptance in the commercial world, but nowhere near the popularity that the *UCP 600* enjoys.[55] The *International Standby Practices (ISP98)* are mostly confined to usage by American banks;[56] and the *UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit* stagnates with only eight signatory

[54] Kelly-Louw and Hugo "Documentary credits and independent guarantees" *ABLU* (2012) 79-88; Hugo "Documentary credits and independent guarantees" *ABLU* (2011) 116-119; Hugo and Kelly-Louw ""Documentary credits and independent guarantees" *ABLU* (2010) 229-237.

[55] Hugo "Construction guarantees and the Supreme Court of Appeal (2010-2013)" in Visser and Pretorius *Essays in honour of Frans Malan* (2014) 159 at 160; Von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 632-633 in par 112-115; Bertrams *Bank guarantees in international trade* (2013) at 29.

[56] Adodo *Letters of credit - The law and practice of compliance* (2014) 11 in par 1.16. See, however, the remarks in Von Westphalen and Zöchling-Jud *Die Bankgarantie im internationalen Handelsverkehr* (2014) 635 in par 126.

states which have actually enacted the *Convention*.[57] Therefore, it is probably justified and pragmatic to focus mainly on the *URDG 758* for future harmonisation in commercial practice – in South Africa, on the African continent[58] and throughout the world.

[57] See UNCITRAL General Assembly document A/CN.9/806 (02nd May 2014) (http://daccess-dds-ny.un.org/doc/UNDOC/GEN/V14/027/12/PDF/V1402712.pdf?OpenElement). The USA has signed, but still has not enacted the Convention.

[58] For example, the *OHADA Uniform Act Organizing Securities* was amended in 2010 and was reported to have adopted and aligned with features and rules based on the *URDG 758*.

Should the benefit of cession of actions be granted to demand guarantors?

Frank Buchhöcker [*]

1 General Introduction

Often parties consider assurance of performance by the other party as a prerequisite for concluding a contract. This assurance is regularly given in the form of a suretyship. Due to the accessory nature of suretyship the enforcement of this assurance, however, is often perceived as too burdensome, especially in an international transaction. This is primarily due to the necessity of proving the backed-up claim in case the creditor wants to call upon the suretyship which may lead to lengthy litigation.[1] This is particularly onerous should the litigation take place in a foreign jurisdiction. Historically, this problem was addressed by a cash deposit made by the assuring party, but this, too, is burdensome as it ties up a considerable amount of cash.[2] Hence it was replaced by the undertaking of a guarantor to pay a certain amount on request, in the form of a demand guarantee.[3] Like the commercial letter of credit, a demand guarantee is an autonomous undertaking independent of the underlying transaction.

Whilst the obligation of the guarantor to pay under a demand guarantee has received considerable attention in South Africa, the same cannot be said for the settlement of claims after the guarantor has fulfilled its obligations. The only settled part thereof is the right of the guarantor to be reimbursed by the applicant for the guarantee – a right arising from the contract of mandate. With reference to the independent nature of the demand guarantee one might argue that this should be the only recourse available to the guarantor. On the other hand the situation of the demand guarantor and the surety after payment are similar: they were both intended to ensure the discharge of an obligation but never meant to bear the costs thereof on their own. In that situation

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[1] Bertrams Bank guarantees in international trade: the law and practice of independent (first demand) guarantees and standby letters of credit in civil law and common law jurisdictions (2004) 2.

[2] Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees* (2008 thesis SA) 1; Horn *J. von Staudingers Kommentar zum Bürgerlichen Gesetzbuch: Staudinger BGB* Buch 2: Recht der Schuldverhältnisse §§ 765 - 778 (Bürgschaft) (2012) Vor §765-778 par 228; Larenz/Canaris *Lehrbuch des Schuldrechts* Band 2 Halbband 2 (1994) 74.

[3] Kelly-Louw (n 2) 1; Bertrams (n 1) 2; Pleyer "Die Bankgarantie im zwischenstaatlichen Handel" 1973 *Wertpapiermitteilungen (WM)* Sonderbeilage Nr. 2 1 7. Pleyer (6) mentions that the demand guarantee is also attractive in this context due to the relative international harmony of the law governing it compared to the law of suretyship; On the similarity see von Marschall "Bankgarantien im internationalen Zahlungsverkehr" 1977 *Arbeiten zur Rechtsvergleichung* Band 87 - Dokumentenakkreditive und Bankgarantien im internationalen Zahlungsverkehr 27 31.

a surety has, in addition to the right for reimbursement, rights of recourse arising from the backed-up claim in the form of the benefit of cession of actions: he can claim cession of the backed-up claim as well as additional claims and securities from the creditor. The benefit of cession of actions thereby ensures that the burden of discharging the backed-up claim is shifted to the appropriate party. One might argue that the benefit of cession of actions should also be applied in the context of demand guarantees to fulfil the very same function for the benefit of the demand guarantor.

This paper tries to answer this issue. It examines whether granting the benefit of cession of actions to the demand guarantor is compatible with the divergent legal characteristics of demand guarantees and suretyships and whether such a step is desirable.

1 1 Demand guarantees

The terminology and names of different kinds of guarantees can be confusing.[4] Thus it is necessary to define what exactly is meant by "demand guarantee". In line with the definition in Article 2 of the Uniform Rules for Demand Guarantees (URDG) 758 it is any signed undertaking by a guarantor to pay on presentation of a complying demand, though subject to the condition that it is intended as a mere security. Thus the demand guarantee has a dual nature: on the one hand it is by its form a primary obligation; on the other, however, it is secondary by intent in that it shall only be called upon in case the backed-up performance is not fulfilled properly.[5]

The term "demand guarantee" includes a guarantee in the form of a letter of credit, the so called "standby letter of credit". It may also stipulate documentary prerequisites, and as such qualify as a documentary credit.

1 2 Parties involved

There are at least three persons involved in a suretyship: the principal debtor, the creditor and the surety backing up the claim of the creditor against the principal debtor. Further parties may include co-debtors of the principal debtor and/or other providers of security such as co-sureties.

This becomes somewhat more complex in the case of demand guarantees. It is still possible that there may be only three parties involved: the creditor, the principal debtor and the guarantor. This is only the case, however, if the principal debtor is also the applicant (the person applying for the issuing of the guarantee), and the creditor is also the beneficiary (the person in

[4] Kelly-Louw (n 2) 1, 5-7.

[5] The formulation primary/secondary in form/intent is used by Kelly-Louw (n 2) 31, 39 although it may originally come from Goode. See Dolan *The law of letters of credit: commercial and standby credits* (1993) par S2-12 n 211 as supplemented.

whose favour the guarantee is issued).[6] This simple situation is used as a starting point. Thus reference to a debtor or applicant normally means a debtor who also applied for the issuance of the guarantee, and reference to the creditor or beneficiary means a creditor who is also the beneficiary of the guarantee and vice versa.

It is also assumed, in the interest of simplicity, that there is only one party, the guarantor, issuing as well as paying the demand guarantee. Should another party, akin to a nominated bank in a commercial letter-of-credit situation, make the payment in terms of a contract of mandate with the guarantor, this should not affect the analysis below, provided the payer has not yet been reimbursed.[7]

1 3 Sources of Law

As is the case in most other jurisdictions, a notable exception being the United States, there is no legislation regarding this issue in South Africa.[8] The question must accordingly be addressed with reference to the law of suretyship, the law of demand guarantees and, perhaps, the law of mandate. Guidance can also be sought in trade usage (common practice) and case law.[9]

To identify usages, practices and the legal principles governing demand guarantees international instruments usually are of great help. Unfortunately, however, the instruments concerning demand guarantees, namely the URDG 758, the Uniform Customs and Practice for Documentary Credits (UCP) 600, the International Standby Practices (ISP) 98 and the UN Convention on Independent Guarantees and Stand-by Letters of Credit (1995), are silent in regard to the matter at hand.[10] They can accordingly be only of limited and indirect assistance.

1 4 Countries covered

The question whether a demand guarantor should have rights of recourse arising from the backed-up claim after payment of the guarantee has received (and continues to receive) significant attention in the United States where it has, in principle, been affirmed in § 5-117 of the Uniform

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[6] This use of "applicant" is not in line with the definition in Article 2 of the URDG 758 but well known in the context of letters of credit and widely used.

[7] § 5-117 (c) Uniform Commercial Code; Byrne *International Letter of Credit Law and Practice* Part 10: Posthonor Remedies Chapter 71: Subrogation (January 2014) §71:11. With reimbursement the backed-up claim should follow according to the previous method of succession: See § 5-117 (c) Uniform Commercial Code; Byrne (n 7) §71:11.

[8] Kelly-Louw (n 2) 94. Other exceptions are Bahrain, Iraq, Kuwait, Oman, and Yemen: see Bertrams (n 1) 157 with further references; Zahn/Ehrlich/Neumann *Zahlung und Zahlungssicherung im Außenhandel* (2001) par 9/13.

[9] Kelly-Louw (n 2) 94.

[10] Byrne (n 7) §71:1 (UN Convention), §71:21 (UCP 600), §71:22 (ISP 98).

Commercial Code. This material has been a valuable source. The extent to which it can be transposed to South Africa, however, is unfortunately hampered as a consequence of the differences in the law of suretyship. A particular reason for that is that the benefit of cession of actions is unknown in the United States and its function is fulfilled by equitable subrogation instead.

The situation in England, as highly influential jurisdiction in South Africa (especially as regards international banking law), is also considered.[11] Unfortunately the issue at hand has not yet enjoyed much attention from either the commentators or the courts in England.[12] In any event, England and the United States are both common-law jurisdictions, and, not surprisingly, the same differences regarding subrogation and the benefit of cession of actions referred to above, are evident.

The German law of suretyship, on the other hand, is reasonably similar in its basic approach to that of South Africa. Hence the arguments regarding the applicability of the benefit of cession of actions to demand guarantees that have emerged in Germany could potentially be transposed to South Africa. German law has been selected as representative of the civil law due to Germany’s economic importance and the author’s familiarity with it.

Due to the divergent backgrounds of the different systems some arguments forwarded in a particular country will not hold water in South Africa. The rejection of such arguments, therefore, does not necessarily mean that they lack persuasive power in general, but merely that they cannot be applied in South Africa. In so far as they are rejected below, therefore, this in no way reflects disrespect to their proponents.

1 5 Structure

I first give an introduction to the benefit of cession of actions and the legal context the law of suretyship provides. Secondly, I deal with the compatibility of the benefit of cession of actions with the principle of independence pertaining to demand guarantees. This, thirdly, leads to the analysis whether the benefit of cession of actions is capable of being applied in the demand-guarantee situation. Finally, the desirability of such application is addressed.

[11] Kelly-Louw (n 2) 14-15.

[12] See also par 5 8 below, especially n 136.

2 The benefit of cession of actions

2 1 Introduction and history

The benefit of cession of actions can be traced back to Roman law.[13] In Roman law the paying surety had no autonomous right to contribution against his co-sureties or any other party liable for the backed-up claim. His only recourse was against the principal debtor.[14] As this was perceived to be inequitable, the concept of a fictitious purchase of the backed-up claim by the surety was constructed: the payment made by the surety was regarded as the purchase price.[15] This construction provided the basis for the paying surety's right to have the backed-up claim and the creditor's rights against the co-sureties ceded to him. It also explained why the surety's payment did not extinguish the backed-up claim despite the rule of Roman law that the claims against the principal debtor and the sureties were the same and that payment of the one extinguished the other.[16] The notion that the surety's payment extinguished the backed-up claim, was also the reason why cession of actions after such payment was precluded.[17]

This was overcome, however, by differentiating between the claims arising out of the different relationships.[18] Thus, today, payment by a surety does not extinguish the backed-up claim; hence the surety can claim cession of actions also after discharging his obligation.[19]

The underlying reason for this right is equity.[20] To deny the paying surety recourse against co-sureties and the co-debtors of the principal debtor, would perpetuate the decision of the creditor to burden that particular surety with the performance of the obligation.[21] This decision, however, is

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[13] Forsyth/Pretorius *Caney´s – The Law of Suretyship in South Africa* (2010) 145; Henning/Mould *Law of South Africa* Volume 26 Chapter Suretyship (2011) par 300.

[14] Henning/Mould (n 13) par 307.

[15] Forsyth/Pretorius (n 13) 146.

[16] Forsyth/Pretorius (n 13) 145-146; Medicus "Der fingierte Klagenkauf als Denkhilfe für die Entwicklung des Zessionsregresses" 1976 *Festschrift für Max Kaser zum 70. Geburtstag* 391 391-396.

[17] Forsyth/Pretorius (n 13) 146; Henning/Mould (n 13) par 300. As Medicus points out it is possible to avoid this preclusion by an appropriate application of the idea of a fictitious purchase. Classically a purchase was only assumed in case a surety claimed cession. Thus payment without claiming cession extinguished the backed-up claim. It would also have been possible, though, to assume a purchase regardless thereof. Thus even without the surety claiming cession before payment, the payment of the surety were to be classified as purchase price leaving the backed-up claim unaffected: Medicus (n 16) 402-405. This point, however, seems not to have been raised in Roman times: Medicus (n 16) 405.

[18] Forsyth/Pretorius (n 13) 146-148. For a critical view in this regard see Henning/Mould (n 13) par 300.

[19] Forsyth/Pretorius (n 13) 147-148; Henning/Mould (n 13) par 300.

[20] Forsyth/Pretorius (n 13) 147.

[21] Although, with regard to co-sureties, there is another way of recourse nowadays. See Forsyth/Pretorius (n 13) 138-144.

an arbitrary one in that there is no reason why that particular surety only should bear the risk that reimbursement by the principal debtor might fail. Another perspective is that of unjust enrichment: if cession of actions were not allowed, payment by one surety would unduly relieve the other debtors and securing parties of their risks.

Law 9 of 1885 of the Colony of Natal, which implemented a *de jure pro rata* cession in favour of secondary obligors, which resulted in a different law of suretyship for that erstwhile colony, is not considered here.[22] It seems, however, that despite the material differences brought about by this colonial legislation, the arguments advanced with regard to the law of the rest of South Africa in principle also apply to the law in Kwazulu Natal.

2 2 Requirements

The right to cession of actions requires that the backed-up claim must be discharged in full.[23] The surety, otherwise, would compete with the creditor which would run counter to the purpose of the suretyship to back up the claim (for example, in the event of the suretyship covering only part of a purchase price which is additionally backed up by a mortgage, the surety would, after paying this part, compete with the seller over the mortgage which might be insufficient to satisfy the whole purchase price and thus the claims of both seller and surety).[24] Moreover, the discharge must, at least to some extent, be performed by the surety.[25]

When it comes to recourse against the principal debtor and contribution by co-sureties it is also required that the performance by the surety must have been actually due and, one might argue, must not have been entered into against the principal debtor's will.[26] These factors, however, are not relevant with regard to the right to cession of actions: their absence does not alter the considerations relating to equity and they have no negative impact on the rights of any parties. In this respect they can accordingly be disregarded.

[22] Regarding that law see Forsyth/Pretorius (n 13) 155.

[23] Forsyth/Pretorius (n 13) 154; Henning/Mould (n 13) par 300. This, of course, is not meant technically because discharging the claim would make its cession impossible. The same applies below.

[24] Forsyth/Pretorius (n 13) 154.

[25] On the one hand there is no room to grant such a right of reimbursement if the surety did not contribute to the discharge of the obligation. On the other hand there seems to be no basis to require the surety to perform the whole obligation by himself. There might, however, be a need to modify the granted right in such a situation as a partial assignment will be impractical and sometimes even impossible. Regarding a surety paying his aliquot share see Forsyth/Pretorius (n 13) 154.

[26] Forsyth/Pretorius (n 13) 160-161, 164-165, 174-175; Henning/Mould (n 13) par 302.

2 3 Effect

The benefit of cession of actions is a claim for cession of actions. It can also be raised, however, as a dilatory defence against the creditors demand for performance of the surety to exact concurrent cession.[27] Primarily such a claim is directed on cession of the backed-up claim.[28] Mostly, therefore, it is of no relevance since the surety, in the normal course of events, also has a right of recourse against the principal debtor.[29] As there are additional requirements, however, there are instances where such a right of recourse is not available but a claim for cession of actions is (for example where the surety entered into the suretyship against the principal debtor´s will or paid in contravention of the contract of mandate).[30]

This autonomous right of recourse, in addition, is only available against co-debtors of the underlying claim in case the surety also guaranteed their obligations (for example where the surety backed up the claims against all members of a syndicate or joint venture, who are liable *in solidum* to perform a building project). This restriction is of no concern when it comes to cession of actions as the right to cession also comprises the claims of the creditor against co-debtors.[31] Hence, even if the surety only backs up the obligation of one member of a syndicate, he will have recourse against the other members based on the benefit of cession of actions.

In addition, the paying surety is entitled to collaterals of the backed-up claim (such as any other suretyships and mortgages).[32] However, because the right to cession may not affect the interests of the creditor, all obligations secured by these collaterals must be discharged.[33] Thus the benefit of cession of actions does not comprise a mortgage which does not only cover the backed-

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[27] *Argumentum e contrario ex* Forsyth/Pretorius (n 13) 158; Henning/Mould (n 13) par 300.

[28] Forsyth/Pretorius (n 13) 152.

[29] Ibid. With respect to its application to demand guarantees: Bertrams (n 1) 156 (dealing with subrogation); Zahn/Ehrlich/Neumann (n 8) par 9/13.

[30] With respect to the application of subrogation to demand guarantees: Dolan (n 5) 7-89.

[31] Forsyth/Pretorius (n 13) 148, 153.

[32] Ibid. With respect to its application to demand guarantees: Castellvi "Zum Übergang der gesicherten Forderung auf den zahlenden Garanten" 1995 *Wertpapiermitteilungen (WM)* 868 868; Förster *Die Fusion von Bürgschaft und Garantie – Eine Neusystematisierung aus rechtsvergleichender Perspektive* (2010) 452-453 with further references; Pleyer (n 3) 21; Boss "Suretyship and Letters of Credit: Subrogation revisited" 1993 *William and Marry Law Review (Wm&MaryLRev)* 1087 1128; McCormack/Ward "Subrogation and Bankers´ autonomous Undertakings" 2000 *Law Quarterly Review (LQR)* 121 125-126 (the latter two articles dealing with subrogation).

Sticking to the developed principles the paying surety could claim the whole amount, reduced by the share he has to bear himself, from each co-surety as long as they do not claim the right of division. His claim would thus not be limited to their individual shares. Some South African courts, however, oppose this notion, with reference to a mere security-function of this claim when it comes to co-sureties and the risk of circuitry of actions. One might prevent such circuitry of actions, though, by having recourse to the underlying reasoning for such a claim, namely equity. See in this regard Forsyth/Pretorius (n 13) 149-152.

[33] Forsyth/Pretorius (n 13) 148.

up claim but also an additional claim which is not yet discharged. If these requirements are met there is no reason to limit the right to cession to accessory securities. In the event that these securities cannot be transferred, the surety should at least be able to claim assignment of their proceeds. It follows that also demand guarantees may be subject to such a claim.[34]

Another interesting feature relates to the different characteristics of the claims: the prescription period of the ceded claims might be more favourable; they might bear higher interest; they might cover more expenses by the creditor; or they could have a preferential status in bankruptcy procedures.[35]

Granted to demand guarantors, the benefit of cession of actions would, if the applicant were not identical with the principal debtor, also enable them to turn to the principal debtor instead of the applicant to obtain reimbursement.[36]

2.4 The context

The benefit of cession of actions is firmly embedded in the law of suretyship.

Should the creditor, due to his careless conduct, be unable to transfer the claims or securities involved to the paying surety, the surety, by virtue of the *exceptio cedendarum actionum (*henceforth the *"exceptio"*), is released, at least pro rata, from his obligation.[37] Hence, in case the creditor releases a co-debtor of the backed-up claim the surety can raise the *exceptio* as a defence against the claim of the creditor under the suretyship – at least to the extent that his reimbursement is endangered due to the loss of this additional recourse.

Due to its accessory nature the obligation of the surety is limited to the amount of the backed-up claim (henceforth the "limitation principle").[38] In the context of the benefit of cession of actions a decrease in the amount of the backed-up claim is accordingly not detrimental to the surety.

The surety, therefore, can rely on the remedies inherently flowing from the benefit of cession of actions: should the underlying claim still be in existence and the creditor is still able to transfer the claims (the backed–up claim and claims against co-debtors) and securities (such as suretyships and mortgages) to the surety, the surety must pay but is entitled to the transfer (cession). If, however, the creditor does not have a valid claim or is no longer able to transfer the

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[34] Pleyer (n 3) 21-22.

[35] Forsyth/Pretorius (n 13) 152-153. With respect to the application of subrogation to demand guarantees: Boss (n 32) 1128; White "Rights of Subrogation in Letters of Credit Transactions" 1996 *Saint Louis University Law Journal (StLouisULJ)* 47 47. The guarantor, however, might be precluded by the contract of mandate to rely on them, but this is a question of interpretation.

[36] Bertrams (n 1) 156; Castellvi (n 32) 868; Förster (n 32) 452-453 especially n 1238; Pleyer (n 3) 21.

[37] Forsyth/Pretorius (n 13) 155-158; Henning/Mould (n 13) par 300.

[38] Forsyth/Pretorius (n 13) 101; Henning/Mould (n 13) par 296.

claims and securities, the surety, in the normal course of events, is relieved from his obligation or, should he nevertheless have paid, acquires a claim against the creditor based on a *condictio indebiti* arising from the limitation principle or the *exceptio*.[39]

2 5 Conclusion

The benefit of cession of actions gives the surety the possibility to make use of the backed-up claim as well as additional claims and securities after discharging the backed-up claim. It does so in order to shift the burden of discharging the backed-up claim to the appropriate party. The manifold effects described make clear that the benefit of cession of actions can thereby improve the situation of a surety significantly. It can in fact make the difference between total failure and complete satisfaction of a reimbursement claim.

The benefit of cession of actions can only do so, however, in case the creditor is still able to cede the claims and securities at the time the surety is entitled to such cession. The surety has no influence thereon. The exceptio and the limitation principle, though, ensure that the surety is granted a corresponding relief should this cause detriment to the surety´s possibilities to have recourse. This will not eliminate the risk faced by the surety: he still has to bear his share of the losses, there might not be additional claims or securities, or they might be of little economic value. It shows, however, that diminution of the surety's security is compensated by corresponding relief. Hence the surety can rely on securities and additional claims in connection with the backed-up claim. The benefit of cession of actions, however, forms only part of this mechanism.

Accordingly it is not only necessary to find out whether the benefit of cession of actions can be applied in the context of demand guarantees but also whether the concomitant limitation principle and *exceptio*, or a functional equivalent thereto, can be adopted in this context.

3 The principle of independence

3 1 Introduction

The principle of independence is better known in the context of commercial letters of credit. There it describes the autonomy of the undertaking of the issuing bank under the letter of credit from the

[39] As indicated by "in the normal course of events" there are some exceptions since the *exceptio* is not based on a prejudice principle but, as mentioned, requires the detriment to be caused by the careless conduct of the creditor. It thus requires a duty of care on the creditor. See Forsyth/Pretorius (n 13) 205 et seqq. It seems correct to imply such duty in the suretyship. See Forsyth/Pretorius (n 13) 207. Thus detriment caused by the creditor results in relief of the surety. Other detriment, however, does not have this result. But these seem to be the natural limitations of securities which the surety would also face if he himself would hold them. Thus, a surety can, but for rather limited exceptions, rely on these claims and securities.

underlying (purchase) agreement.[40] It is derived from the contractual arrangements between the parties.

The issuing bank is not a party to the underlying contract. Due to the principle of privity of contract, the relationship between the issuing bank and beneficiary of the letter of credit is not automatically affected by the underlying relationship. Without further indication, though, one would be inclined to construe such a link due to the parties' intention to discharge the payment obligation of the underlying sale agreement by the letter of credit. For this reason the drafters of letters of credits and their rules are at pains to emphasise that this underlying economic purpose, and every reference to the underlying (purchase) agreement in the instrument, are not intended to create such a link to ensure prompt payment.[41]

On the basis of the independence principle the issuing bank must pay the seller on presentation of complying documents, regardless of the existence of any claim the seller might have against the buyer. The bank must accordingly pay even if the shipped goods turn out to be nonconforming and worthless.[42] As a consequence of such payment, moreover, the buyer will be obliged to reimburse the bank.[43] Hence the buyer will pay and the seller will receive the money irrespective of the existence of a valid claim by the seller against the buyer. Thus the seller, and not the buyer, as in the case of an open account, will have the money at his disposal during any ensuing litigation concerning, for example, the conformity of the delivered goods.[44] This is one of the major benefits for the seller where payment is to occur by means of a letter of credit.

In addition the principle of independence relieves the issuing bank from all uncertainty regarding the existence and enforceability of the underlying contract which it otherwise might have had to investigate.[45] It further serves to contain any dispute emanating from this contract to the

[40] *Phillips v Standard Bank of South Africa Ltd* 1985 3 SA 301 (W) 304A-B. It also describes the autonomy of the undertaking from issuer´s relation to the buyer, the contract of mandate, but this is of no further relevance here. The commercial letter of credit is not limited to facilitate payments of a purchase prize but can do the same for every other payment obligation. Nevertheless this scenario is used to illustrate the inter-party relation as it is its classical field of use and rather simple.

[41] For example Article 4 a UCP 600: "A credit is by its nature a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationship with the issuing bank or the beneficiary."

[42] *Ex Parte Sapan Trading (Pty) Ltd* 1995 1 SA 218 (W) 224-225.

[43] Avidon "Subrogation in the Letter of Credit Context" 1990 *Brooklyn Law Review (BrookLRev)* 129 130.

[44] *Phillips v Standard Bank of South Africa* (n 40) 303E-F.

[45] Habersack *Münchener Kommentar zum Bürgerlichen Gesetzbuch: BGB* Band 5: Schuldrecht - Besonderer Teil III (2013) Vor §765 par 27; Bertrams (n 1) 2.

buyer and the seller – the parties of the contract concerned - and allows them to arrange their affairs independent of the demand guarantee.[46]

3 2 Applicability to demand guarantees

The guarantor is not a party to the underlying contract between the creditor and the principal debtor. Moreover, as in the case of commercial letters of credit, demand guarantees and the regulatory instruments pertaining to them, emphasize the independence of the undertaking from the underlying relation.[47] Hence the principle of independence is also applicable to demand guarantees.[48]

As the independence principle is not derived from the particular form of the undertaking, but from the separate contractual relations between the parties and the interpretation of the guarantor's undertaking, its application to demand guarantees does not depend on whether or not they are issued in the form of a letter of credit (the so-called "standby letter of credit" popular in the United States).[49]

3 3 Scope of the principle of independence

Finding an answer to the question about the scope of the principle of independence proves more difficult. When the principle is described in general terms, the independence of the demand

[46] Regarding the containment of a dispute: Habersack (n 45) Vor §765 par 27-28; Canaris *Großkommentar zum Handelsgesetzbuch - begründet von Hermann Staub* Band 5 (2005) par 1142; Larenz/Canaris (n 2) 244; Bertrams (n 1) 2. Regarding the latter purpose: Joint Building Contracts Committee *Construction Guarantee – For use with the JBCC Principal Building Agreement* (2000 series) in Finsen *The Building Contract - A Commentary on the JBCC Agreements* (2005) Appendix 5 Clause 9.0: "9.0 The Employer shall have the absolute right to arrange his affairs with the Contractor in any manner which the Employer deems fit".

[47] For example in Article 5 a URDG 758 or Rule 1.07 ISP 98: "An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law." and Joint Building Contracts Committee *Construction Guarantee* (n 46) Appendix 5 Clause 3.1: "Any reference in this Guarantee to the Agreement is made for the purpose of convenience and shall not be construed as any intention whatsoever to create an accessory obligation or any intention whatsoever to create a suretyship.".

[48] *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd* 2010 2 SA 86 (SCA) par 20: *"*The guarantee by Lombard is not unlike irrevocable letters of credit issued by banks and used in international trade, the essential feature of which is the establishment of a contractual obligation on the part of the bank to pay the beneficiary (seller). This obligation is wholly independent of the underlying contract*".* See also *First Rand Bank Ltd v Investments CC* 2013 5 SA 556 (SCA) par 2, 11; *Guardrisk Insurance Co Ltd v Kentz (Pty) Ltd* 2014 1 All SA 307 (SCA) par 14, 19, 27-29; *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 2 SA 382 (SCA) par 10-25; Bertrams (n 1) 11; Zahn/Ehrlich/Neumann (n 8**Error! Bookmark not defined.**) par 9/15; Avidon (n 43) 130. See further in similar vein *Edward Owen Engineering Ltd v Barclays Bank International Ltd* (1978) 1 All ER 976 (CA) 983.

[49] See the wide formulation in Article 2 I United Nations Convention on Independent Guarantees and Stand-by Letters of Credit *(1995)* and Article 1 a URDG 758.

guarantee from the underlying relation is often named, which implicitly repudiates any link between them whatsoever.[50]

Judge Becker, on the other hand, stated in his minority opinion in the *Tudor Development* case, which is of special interest as it was indorsed in the revised §5-117 of the Uniform Commercial Code, that "the point of the independence principle is not to set up a wall for the sake of a wall, but to serve certain purposes".[51] The inference is that the principle of independence does not apply in instances in which it does not serve such a purpose.[52]

On this basis one might argue that the principle of independence only applies if "pay now, argue later" [53] is concerned. This would satisfy the beneficiary's interest to swift payment even in case of a dispute regarding the underlying transaction. It would also satisfy the guarantor's interest not to be encumbered by the facts of the underlying transaction but rather to focus on the conformity of the demand (and accompanying documents if there are any), when the guarantee is called up. Accordingly the principle of independence would only claim effect till discharge of the guarantee.

As the principle of independence is based on the repudiation of a link or nexus with the underlying contract in the demand guarantee and therefore a contractual clause, the answer should be sought by way of interpretation. The wording of those clauses, however, differ significantly. Some repudiate any link between the guarantee and the underlying relationship whatsoever.[54] Others limit the independence on the obligation of the guarantor to pay and therefore the issue of "pay now, argue later".[55] It does not seem advisable, however, to attach too much importance to the wording of those clauses. The question at hand was presumably not taken into consideration in the process of formulating the clauses because the principle of independence

[50] *Ex Parte Sapan Trading (Pty) Ltd* (n 42) 223I-224C; *Phillips v Standard Bank of South Africa* (n 40) 303A, 304A-B. See also n 54.

[51] *Tudor Development Group Inc v United States Fidelity and Guaranty* 968 F2d 357 (3rdCir 1992) indorsed minority judgment 368; 1st Comment to the revised § 5-117 of the Uniform Commercial Code.

[52] According to Byrne (n 7) §71:6 the drafting group of the revised §5-117 of the Uniform Commercial Code made the same point.

[53] Formulation borrowed from *Eakin v Continental Ill Nat´l Bank &Trust Co* 875 F2d 114 (7thCir 1989) 116.

[54] For example Article 4 a UCP 600: "A credit is by its nature a separate transaction from the sale or other contract on which it may be based." and Article 5 a URDG: "A guarantee is by its nature independent of the underlying relationship (…)".

[55] For example Rule 1.07 ISP 98: "Independence of the issuer-beneficiary relationship: An issuer's <u>obligations</u> toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law." (My emphasis) and Article 3 United Nations Convention on Independent Guarantees and Stand-by Letters of Credit *(1995)*: "For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's <u>obligation</u> to the beneficiary is not: (a) Dependent upon the existence or validity of any underlying transaction (…)". (My emphasis)

is regularly equated with its role in the matter of "pay now, argue later".[56] Hence the preference of one wording over the other does not amount to a decision regarding the issue at hand.

The parties, on the other hand, do not expect a link between the demand guarantee and the underlying transaction be it before discharge of the guarantee or thereafter.[57] That would be in conflict with a narrow understanding of the principle of independence. Restricting the principle of independence to its function to ensure "pay now, argue later" would also ignore other benefits of the autonomy of the backed-up claim from the underlying transaction, notably to contain any dispute emanating from the underlying transaction to the parties thereof and to enable those parties to arrange their affairs independent of the demand guarantee.[58]

From this perspective it would appear that the contractual implementation of the principle of independence is not limited to the "pay now, argue later" principle. It therefore does not amount to "honouring form over substance"[59] to take the principle of independence into account where "pay now, argue later" is not concerned: irrespective of whether or not swift payment is at stake it requires good cause to depart from the autonomy of the demand guarantee from the underlying transaction.[60] In this regard, however, the purpose of the independence principle is important, and there is no doubt that ensuring "pay now, argue later" is its most important purpose. Only in this respect can the principle of independence be said to be "the lifeblood of international commerce".[61] Its significance in this context cannot be transposed to its application in general.

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[56] This is presumably different when it comes to international instruments but their restrictive understanding of the principle of independence is presumably owed to their inclusive character.

[57] Otherwise the guarantor would be interested in the underlying transaction and consequently investigate it, what he regularly does not do. Dolan "A Study of Subrogation Mostly in Letter of Credit and other Abstract Obligation Transactions" 1999 *Missouri Law Review (MoLRev)* 789 824 et seqq with further references.

[58] Regarding those aims see n 45 and 46.

[59] *In re Minnesota Kicks Inc* 48 BR 93 (BankrDMinn 1985) 105; approved in *Tudor Development* (n 51) indorsed minority judgment 367 which even repeated the substance of this position at 368.

[60] The judgments mentioned in n 50 do not necessarily support that point as they deal with questions of prompt payment. The implicit statement that the principle of independence reaches further than "pay now, argue later" is therefore obiter if not unintended.

Repudiating subrogation as a breach of the principle of independence and therefore supporting a wide understanding of the principle of independence: *In re Economic Enterprises Inc* 44 BR 230 (BankrFConn 1984) 232; *In re Carley Capital Group* 119 BR 646 (BankrDWDWis 1990) 651.

Reducing the principle of independence to the purpose of "pay now, argue later": *Tudor Development* (n 51) indorsed minority judgment 356-366, 368. The judgment of the majority is ambiguous on this point (360, 363). Also in favour of this narrow understanding of the principle of independence: McCormack/Ward (n 32) 135; Avidon (n 43) 136-138; Boss (n 32) 1121, 1125; Byrne (n 7) §71:3. Dolan also limits the principle of independence to the obligation of the guarantor to pay but qualifies this by looking at the practical effects, recognising post payment links as a threat thereto (n 57) 803.

[61] *R D Harbottle (Mercantile) Ltd and Another v National Westminster Bank Ltd and Others* (1977) 2 All ER 862 (QB) 870b-d as approved in SA with regard to (commercial) letters of credit in *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 1 SA 812 (A) 816D-I. A similar formulation in *Intraco Ltd v Notis Shipping Corporation (The Bhoja Trader)* (1981) 2 Lloyd's Rep 256 (CA) 257 was cited in context of guarantees in *Coface* (n 48) par 12.

Since only a conflict with the principle “pay now, argue later” would be a conclusive argument against the application of the benefit of cession of actions, the analysis in this paragraph is limited to the principle of independence in the narrow sense, the issue of “pay now, argue later”. Any other interference with the independence principle is dealt with as part of the discussion of the desirability of extending the benefit of cession of actions to demand guarantees.

3 4 Impact on the benefit of cession of actions

In the context of suretyship the benefit of cession of actions is basically a post-honour remedy, although it can be raised as a dilatory plea and thereby force cession to be concurrent with performance of the surety.[62] This dilatory defence, however, is not necessary to ensure the benefit of cession of action´s function and can be waived by the surety.[63] It is therefore separable from the rest of the benefit of cession of actions. As it is also inconsistent with the principle of independence in its narrow sense it should not be granted to demand guarantors and will not be taken into account in the further analysis.

The benefit of cession of actions without the dilatory defence only takes effect after discharge of the backed-up claim and, by necessary implication, after discharge of the obligation of the surety. The same would hold true if the benefit were to be applied to demand guarantees.[64] The application of this rule in the guarantee context is, however, more problematic: since the underlying claim and the demand guarantee are independent of each other the discharge of one does not indicate the discharge of the other. Moreover, it might also be difficult to determine exactly what claims are in fact backed-up by the guarantee.[65] These are nevertheless mere practical problems as opposed to problems in legal principle.

For the benefit of cession of actions to arise potentially, the guarantee would have to be fully discharged. As such the benefit is not capable of interfering with the obligation of the guarantor to pay. Therefore the benefit of cession of actions would not interfere with the “pay now, argue later” principle, and, synonymic, with the principle of independence in its narrow sense.[66]

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[62] n 27.

[63] Regarding the possibility to waive this defence see n 27.

[64] Stressing this requirement: §5-117 (d) Uniform Commercial Code and its 2nd official comment; Avidon (n 43) 137-138; Byrne (n 7) §71:8; Dolan (n 57) 801 et seqq.

[65] Mentioning this difficulty: White (n 35) 51.

[66] *Tudor Development* (n 51) majority judgment 360, indorsed minority judgment 367-368; Bertrams (n 1) 157; Byrne (n 7) §71:3.

3 5 Impact on the exceptio and the limitation principle[67]

3 5 1 Exceptio cedendarum actionum

Any release of the guarantor from his obligations under the demand guarantee as a consequence of developments relating to the backed-up claim, on the other hand, would affect directly the principle of independence in the narrow sense: the guarantor would then be able to defend himself with reference to events in connection with the underlying transaction.[68] Thus the beneficiary may need to argue before being paid. For this reason guarantees in some cases even specifically provide that the *exceptio* is not available.[69]

There is, however, another way to achieve the aims of the *exceptio.* Should a surety pay despite having a defence arising from the *exceptio*, he has a claim for repayment in the form of a *condictio indebiti*.[70] It is conceivably possible that the guarantor may have a similar claim. If such a claim would take effect only after the guarantor fully discharged his obligation under the guarantee, the principle of independence in its narrow sense would technically not be violated.[71] One basis for the recognition of such a claim would be a tacit term of the guarantee. Another is the *condictio indebiti*.[72]

In this manner benefits akin to those arising from *exceptio* could be made applicable to demand guarantees.

3 5 2 The limitation principle

The same applies to the limitation principle. Should the guarantor's obligation be limited to the amount of the backed-up claim, such limitation would make it necessary for the beneficiary to

[67] Regarding the *exceptio* and the limitation principle see par 0above.

[68] Zahn/Ehrlich/Neumann (n 8) par 9/13. Also rejecting such a defence with regard to standby letters of credit: Boss (n 32) 1089, 1095 et seqq, 1121-1126. Pleyer (n 3) 20, however, wants to allow the *exceptio*, if the guarantor was aware of the remedies flowing from the benefit of cession of actions before issuing the guarantee. The revised §5-117 (d) of the Uniform Commercial Code also takes a stand against such a defence as its 2nd Comment makes clear. See White (n 35) 61.

[69] See, for example, Joint Building Contracts Committee *Construction Guarantee* (n 46) Appendix 5 Clause 9.0: "The Employer shall have the absolute right to arrange his affairs with the Contractor in any manner which the Employer deems fit and the Guarantor shall not have the right to claim his release from this construction guarantee on account of any conduct alleged to be prejudicial to the Guarantor." (My emphasis).

[70] Regarding the *condictio indebiti*-claim of the surety for repayment see par 0above.

[71] Though it might have a negative indirect effect on a swift payment, see par 5 7 below.

[72] Regarding the source of inspiration for such claims for repayment as well as further references see par 3 5 4 below.

prove the existence of the backed-up claim.[73] One of the main reasons for implementing the "pay now, argue later" principle by requiring an independent demand guarantee as opposed to a suretyship, is to prevent this very situation.

Here, too, however, the principle would not be violated by a claim of the guarantor against the beneficiary after full payment of the guarantee. Hence, in lieu of the limitation principle, the guarantor could conceivably be granted a claim for repayment against the beneficiary after discharge of the guarantee.

It seems obvious that an amount correctly paid by the guarantor in accordance with the guarantee but not owed by the principal debtor to the creditor must be repaid. This was accepted by the Supreme Court of Appeal in the *Dormell* case.[74] A separate question is to whom the creditor has to pay the amount: the principal debtor or the guarantor. A claim by the principal debtor could be based on a tacit term of the underlying contract or the collateral contract.[75] A claim by the guarantor could be based on unjust enrichment (especially in form of the *condictio indebiti*) or a tacit term of the guarantee. Another way might be to grant the right for repayment to the principal debtor but assign it at the same time to the guarantor analogous to the entitlement of the surety to the counter-performance of the underlying transaction.[76]

The majority judgement in the *Dormell* case seems to consider it immaterial whether the principal debtor or the guarantor is entitled to the repayment in such case.[77] *Guardrisk*, on the other hand, attacks the majority judgment on the ground that the question of repayment was raised in a dispute between the "financial institution" and the beneficiary and not between the parties to the underlying transaction.[78] Thus the question is not settled in South African law.[79]

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[73] n 68.

[74] *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 1 SA 70 (SCA) majority judgment 84C. The minority judgement as well as the *Coface* (n 48) judgment do not attack it at this point. See also *Cargill International SA and Another v Bangladesh Sugar and Food Industries Corporation* (1996) 2 Lloyd´s Rep 311 (Comm): "However, it seems to me implicit in the nature of a bond (…) that, in the absence of some clear words to a different effect, when the bond is called, there will, at some stage in the future, be an 'accounting' between the parties in the sense that their rights and obligations will be finally determined at some future date." For affirmation see *Cargill International SA and Another v Bangladesh Sugar and Food Industries Corporation* (1998) 2 All ER 406 (CA) with further references.

[75] *Cargill* (Comm) (n 74), which also speaks very much in favour of an accounting between the parties of the underlying contract, with reference to two Australian cases and English literature to this end.

[76] See par 5 6 below, especially n 131. Regarding the counter-performance in case of a suretyship see Henning/Mould (n 13) par 301.

[77] *Dormell* (n 74) majority judgment 84C.

[78] *Guardrisk* (n 48) par 26. *Coface* ((n 48) par 23 2nd sentence) as well as Cloete JA in his minority judgment in the *Dormell* case ((n 74) 91D-92F) also attack the majority judgement in *Dormell* on this point, although indirectly.

[79] It is interesting to note, however, that the Joint Building Contracts Committee in the form for Construction Guarantees and analogous forms grant the guarantor the right to repayment in case he is a registered insurer. See Joint Building Contracts Committee *Construction Guarantee* (n 46) Appendix 5 Clause 7.0: "Where the Guarantor is a registered insurer and has made payment in terms of 5.0, the Employer shall upon the date of issue of the final payment certificate submit an expense account to the Guarantor showing

3 5 3 US Subrogation

According to the law of the United States, subrogation, in contrast to the benefit of cession of actions, leads to the acquisition by the paying surety of the claims also of the principal debtor relating to the underlying transaction.[80] Accordingly the revised § 5-117 of the Uniform Commercial Code expressly states that the guarantor can be subrogated to the beneficiary's rights as well as to those of the principal debtor.

Hence the guarantor has a claim for repayment of an amount paid under the demand guarantee which was not due in terms of the underlying contract, even if one assumes that it is the debtor and not the guarantor who is originally entitled to it. In the event of the creditor calling up a guarantee without having a claim against the principal debtor, the latter has a claim for repayment against the creditor. This qualifies as a claim of the principal debtor in connection with the underlying transaction; thus the guarantor is subrogated to it.[81] Hence in the United States the guarantor has a claim compensating him for the inapplicability of the limitation principle.

However, the same cannot be said of the position in the case of the *exceptio cedendarum actionum*.

3 5 4 The German "Bürgschaft auf erstes Anfordern"[82]

The idea of claims compensating the guarantor for the inapplicability of the *exceptio* and the limitation principle is borrowed from German law.

Apart from guarantees payable on first demand, German law recognises a suretyship payable on first demand, the so-called *Bürgschaft auf erstes Anfordern.*[83] In accordance with this

how all monies received in terms of the Construction Guarantee have been expended and shall refund to the Guarantor any received in terms of the Construction Guarantee have been expended and shall refund to the Guarantor any resulting surplus." (My emphasis). This indicates that the JBCC assumes a right for repayment of the debtor in the normal course of events. And there is some reason to do so if focusing on the autonomy of the undertaking from the underlying contract and English law. See in this regard n 75.

[80] Lease/Kennel *Corpus Juris Secundum* Chapter Subrogation (September 2014) § 82. For the same issue with regard to letters of credit: *Tudor Development* (n 51) majority judgment n 3; Byrne (n 7) §71:10; White (n 35) 58-59.

[81] Similar but rather cautiously: Byrne (n 7) §71:10. This question remains relevant, though, as it governs the question whether the creditor can raise defences he has against the debtor also in relation to the guarantor regarding the repayment. See par 5 6 below, especially n 131.

[82] "Suretyship on first demand".

[83] Habersack (n 45) §765 par 98; Horn (n 2) Vor §765-778 par 24.

legal device, the surety must pay on first demand.[84] He cannot, in reliance upon the *exceptio* or the limitation principle, escape payment.[85] The surety, for example, has to pay in case of a complying demand even if the backed-up claim does not exist – provided the demand is not in bad faith.[86] Having paid, however, the surety has recourse against the beneficiary as if the obligation to pay was limited to the amount of the backed-up claim and protected by the *exceptio*.[87] The courts base this claim on the *condictio indebiti*, alike to the claim for repayment by a normal surety.[88] This notion, however, depends upon a rather strange legal fiction.[89] The better way probably is to base it upon a tacit term of the suretyship in terms of which the beneficiary is bound to repay such amounts to the surety.[90]

German law does not, however, regard demand guarantees, as utilised in international trade, as *Bürgschaft auf erstes Anfordern*.[91] Demand guarantees fall into a different category which is not covered by the statutory provisions regulating suretyship or any other statutory provisions. Accordingly the question how they should be dealt with is controversial.[92]

3 5 5 The effect

A surety, as *shown* above, can, in the context of the benefit of cession of actions, in general rely on all securities and claims available to the creditor.[93] The surety's position is entrenched by the availability of the *exceptio* as well as by the principle that the surety's liability is limited to the

[84] Habersack (n 45) §765 par 98; Horn (n 2) Vor §765-778 par 24, 28.

[85] Ibid.

[86] Regarding the exception of bad faith see Habersack (n 45) Vor 765 par 34, §765 par 103; Horn (n 2) Vor §765-778 par 36.

[87] Habersack (n 45) §765 par 104; Horn (n 2) Vor §765-778 par 24, 32 and 37. Some scholars argue that the obligation to pay on first demand contradicts the accessority necessary to qualify the instrument as suretyship and therefore reject the concept of the *Bürgschaft auf erstes Anfordern.* The supporters of this concept, on the other hand, argue that the obligation to pay on demand does not eliminate the accessority of this obligation but merely postpones its effect. Regarding this controversy see Förster (n32) 316-320 with further references; Habersack (n 45) §765 par 98.

[88] Förster (n 32) 312; Horn (n 2) Vor §765-778 par 37; Larenz/Canaris (n 2) 81.

[89] Larenz/Canaris (n 2) 81.

[90] Habersack (n 45) §765 par 104; Larenz/Canaris (n 2) 81.

[91] Habersack (n 45) Vor §765 par 19, 27.

[92] For example regarding the question whether the benefit of cession of actions is available to the guarantor: while Von Caemmerer "Bankgarantie im Außenhandel" 1964 *Festschrift für Otto Riese aus Anlass seines siebzigsten Geburtstages* 295 306; Larenz/Canaris (n 2) 77 and Pleyer (n 3) 21 advocate its availability, Habersack (n 45) §774 par 2 and Horn (n 2) §774 par 61 oppose it. Förster (n 32) 448-455 also advocates it, provides further references to both opinions and discusses the question with references to other legal systems.

[93] See par 0above. Regarding the exceptions see n 39.

amount of the backed-up claim. But what would the situation be in the event of the benefit of cession of actions being granted to guarantors?

This would *mean* that the guarantor could make use of the backed-up claim as well as other securities available to the creditor that are still in existence at the time of the full discharge of the backed-up claim (and can therefore be ceded to him). In the event of there being no backed-up claim (for example due to the fact that the creditor's alleged claim for damages does not exist), or claims against co-debtors and securities have fallen away (for example because the creditor released sureties from their obligations), however, this would not provide the guarantor with a defence. In this respect, therefore, the position of the guarantor differs materially from that of the surety. This is the case because, unlike the surety, the guarantor, due to the independence of the guarantee, cannot rely on a limitation of his liability to the amount of the backed-up claim or on the *exceptio cedendarum actionum.* Nor would the guarantor be compensated for this in any way.

This lacuna could be rectified, however, by allowing to the guarantor a claim against the creditor/beneficiary. In the event of the backed-up claim and its securities still being intact at the time of discharge of the guaranteed debt by the guarantor, the guarantor would be able to make use of them due to the benefit of cession of actions.[94] Should they no longer be intact, however, the guarantor could conceivably have a claim against the beneficiary compensating him for this loss. Hence, if the creditor/beneficiary released a co-debtor, thereby prejudicing the guarantor's potential rights against that co-debtor, the guarantor may have a claim against the beneficiary for causing this prejudice.

3 6 <u>Conclusion</u>

Thus the benefit of cession of actions itself is not in conflict with the principle of independence in the narrow sense. The other mechanisms available to a surety that strengthen his position in relation also to accompanying claims and securities, namely the *exceptio cedendarum actionum* and the limitation of his liability to the amount of the backed-up claim, on the other hand, are inconsistent with the independence principle. This problem could potentially be addressed, however, by allowing the guarantor a claim against the creditor/beneficiary in the event that cession of such claims and securities is no longer possible.

4 Compatibility with the benefit of cession of actions

For the benefit of cession of actions to be made applicable to demand guarantees the benefit must be compatible with such guarantees. The main difference in principle between suretyship and the

[94] Regarding these claims see par 3 5 1 and 3 5 2 above.

demand guarantee is that while suretyship is accessory and secondary, the demand guarantee is independent and primary. A direct liability of the issuer, on the other hand, is not a distinction between independent guarantees and suretyships but unifies them as both surety and guarantor, are primarily discharging their own obligation towards the creditor when paying.[95]

The materiality of the differences in the context of the benefit of cession of actions is scrutinised in the following paragraph.

4 1 Accessority

The accessority of suretyship refers to the fact that the suretyship is dependent upon the backed-up claim.[96] The benefit of cession of actions, however, works the other way around: the suretyship impacts upon the backed-up claim by replacing the original creditor with the surety.[97] In addition they deal with quite distinct issues: the accessory nature of suretyship is relevant only until the surety has paid; the benefit of cession of actions, on the other hand, only takes effect thereafter.[98] These are merely symptoms of their divergent aims: the former limits the surety's liability, the latter ensures his recourse.

Therefore accessority is not required in principle for the benefit of cession of actions.[99]

4 2 Secondarity

A surety is normally secondarily liable in two respects.

Firstly a surety is normally secondarily liable towards the creditor in that the creditor must try to obtain the performance from the principal debtor before he is entitled to call on the surety.[100] A demand guarantor does not have this benefit.[101] The surety, however, does not have to avail himself of the benefit; he can rely upon it in proceedings or refrain from doing so, and can even renounce it right from the beginning.[102] Such renunciation does not cast doubts on his being a

[95] *Tudor Development* (n 51) indorsed minority judgment 365-366; Boss (n 32) 1108-1111.

[96] Forsyth/Pretorius (n 13) 29-30; Castellvi (n 32) 870.

[97] Castellvi (n 32) 870. See in similar vein Förster (n 32) 453-454.

[98] Castellvi (n 32) 870. See in similar vein Boss (n 32) 1110-1112; Dolan (n 57) 800.

[99] Förster (n 32) 450-454 with further references, and also as to the opposite view 448, 453-454.

[100] Forsyth/Pretorius (n 13) 125 et seqq; Henning/Mould (n 13) par 298; §§771-772 *Bürgerliches Gesetzbuch* (German Civil Code).

[101] Boss (n 32) 1106. Taking that as an argument against subrogation in the context of standby letters of credits: *Tudor Development* (n 51) majority judgment 362; more broadly: Dolan (n 5) par 2-53-54.

[102] Forsyth/Pretorius (n 13) 127, 130-131, 134; Henning/Mould (n 13) par 298.

surety, or his entitlement to the benefit of cession of actions.[103] Hence secondarity in this sense is not a prerequisite for being entitled to the benefit of cession of actions.[104]

Secondly the surety is secondarily liable towards the principal debtor in that the principal debtor is the party who should ultimately pay the backed-up claim. When it comes to demand guarantees, however, it is also the principal debtor who should ultimately pay: although the guarantor must pay on demand, the guarantee does not shift the burden of the backed-up claim to the guarantor; it remains with the principal debtor due to the guarantor's right to reimbursement.[105] Therefore a demand guarantor is also secondarily liable in this sense.[106]

Thus, secondarity is also no obstacle for the application of the benefit of cession of actions to demand guarantees.

4 3 Conclusion

So viewed it appears that the benefit of cession of actions is not in principle incompatible with demand guarantees.

5 Desirability

The conclusion that the benefit of cession of actions is not in legal principle incompatible with demand guarantees, however, is not the end of the matter. The question remains whether it is desirable that this benefit be applied to demand guarantees. In this regard it should be stressed that any exception to the principle of independence must be justified.[107]

5 1 Similarity with suretyship

The similarity of demand guarantees and suretyships has only limited persuasive power.[108] One might argue that demand guarantees are closely related to suretyships and should therefore resemble them as far as allowed by the main difference, "pay now, argue later". This does not, however, take into account that there are also other differences.

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[103] §773 *Bürgerliches Gesetzbuch* (German Civil Code); Castellvi (n 32) 869; McCormack/Ward (n 32) 139-140; American Law Institute *Restatement (third) of Suretyship and Guaranty* (1996) §1 Comment j; Boss (n 32) 1106-1108.

[104] Castellvi (n 32) 869-870; Boss (n 32) 1106-1106.

[105] Förster (n 32) 447, 452-453; Pleyer (n 3) 21; *Tudor Development* (n 51) indorsed minority judgment 361.

[106] Boss (n 32) 1115 et seqq.

[107] See par 3 3 above.

[108] Raising this argument: Von Marschall (n 3) 33.

In addition it ignores the other relative of the demand guarantee, namely the cash deposit, which resembles the demand guarantee in certain respects.

These questions need to be analysed in more detail.

5 2 The benefit of the guarantor

The advantages to the guarantor of allowing him the benefit of cession of actions would be numerous: the guarantor would acquire a claim against the principal debtor irrespective of the fact that he may have no such claim in terms of the contract of mandate; moreover, he would have recourse against other existing debtors and providers of securities; and, finally, he could profit from specific aspects or characteristics of the underlying claim that may favour him.[109]

As pointed out above, the backed-up claim as well as claims against co-debtors and securities would, however, be dependent on them being in existence at the time the guarantor discharges the guarantee.[110] In the event of the creditor, for example, having released a co-debtor or surety, the guarantor would have no recourse against them, and, unlike the surety, will not be released from his obligation to pay in terms of the guarantee in these circumstances. Although it is conceptually possible to address this problem to some extent by granting to the guarantor a claim against the beneficiary in such circumstances, this would link the demand guarantee closer to the backed-up claim (which is problematic in the context of the independence principle governing such guarantees).[111] Moreover, the recognition of a right to be compensated by the beneficiary in the event of the beneficiary prejudicing the guarantor's potential recourse against other debtors or securities, would severely affect the beneficiary´s freedom to arrange his affairs as he deems fit (a freedom not typically intended to be affected by the guarantee).[112] The creditor may well, for example, refrain from a settlement with a co-debtor due to the fact that such settlement may expose him to a claim by the guarantor.

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[109] See par 2 3 above. These benefits, however, could be limited by tacit terms of the contract of mandate.

[110] See par 3 5 5 above. Von Caemmerer (n 92) 306 addresses the risk that the debtor might be able to defend himself against such a claim but attributes little importance to it as he, without further ado, assumes that the creditor will normally have an enforceable claim against the debtor. Pleyer (n 3) 21 mentions the possibility that the backed-up claim might not exist after all but does not reach any conclusion in this regard. Byrne (n 7) §71:8, on the other hand, seems only to address the economic risks of the rights granted by subrogation and not these legal pitfalls.

[111] Regarding this possibility see par 0above.

[112] This point is underlined by the fact that the *exceptio cedendarum actionum* would, even if in accordance with the principle of independence in its narrow sense, rarely take effect in the context of guarantees as there seems to be no basis to imply a duty of care regarding the claims and securities as required by the *exceptio*. See n 39 in this regard. As to the intention to uphold the beneficiary´s freedom to arrange his affairs according to his will see n 46.

Furthermore, the recognition of such a right would in any event still not render the guarantor's position as secure as that of a surety: while the surety is not obliged to pay at all in these circumstances, the guarantor would only acquire a current claim against the creditor (which he would need to enforce) and would therefore be exposed to the risk of the creditor's insolvency.

The position of the paying guarantor is somewhat better in the United States: by subrogation the paying guarantor also acquires the rights of the principal debtor relating to the underlying transaction. This includes any right the principal debtor may have against the creditor for repayment of any amount called up by the creditor in excess of the valid claim of the creditor against the principal debtor. Hence subrogation, in the normal course of events, at least provides the guarantor with an additional claim against either the principal debtor (in case such claim does exist) or the creditor (in case the backed-up claim does not exist).[113]

5 3 The accepted risk

The benefit of cession of actions in the field of demand guarantees is often attacked on the basis that the guarantor could have contracted for securities (such as a mortgage bond) himself; hence he has only himself to blame for not taking sufficient securities.[114] This line of argument is regularly opposed on two grounds: first, the same could be said about the surety to whom this recourse is nevertheless granted; and, secondly, that the guarantor would have no reason to contract for securities he expects to acquire by law.[115]

In the event of only the benefit of cession of actions and no accompanying remedies being granted to the guarantor, however, his position would still be markedly different from that of the surety: as shown above a surety can rely on remedies inherently flowing from the benefit of cession of actions.[116] He therefore has no reason to contract for a benefit that he acquires by law. A guarantor, on the other hand, is in a less favourable position: additional claims and securities (for example mortgages or liens) might no longer be in existence and/or the backed-up claim itself may be non-existent or useless. Thus a guarantor would still assume the risk of a shortfall in reimbursement if he does not take sufficient additional collaterals (for example in the form of a

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[113] Regarding the situation in the US see par 3 5 3 above.

[114] *Tudor Development* (n 51) majority judgment 363, and further references in the indorsed minority judgment 368-369; Avidon (n 43) 136; Dolan (n 5) par 7-87, 7-89, S-7-20-21 as supplemented, "The Vice of Subrogation: Interfering with the Risk Allocation Post Payment" 1995 *Journal of Payment Systems Law (JPaymentSysL)* 229 229 et seqq, 234 et seqq, (n 57) 790, 819 et seqq; further references in Byrne (n 7) §71:5 in n 5 and in Boss (n 32) 1099 et seqq.

[115] McCormack/Ward (n 32) 143; *Tudor Development* (n 51) indorsed minority judgment 369; further references in Dolan (n 57) 821 n 116. See in similar vein Förster (n 32) 454; Boss (n 32) 1100-1102, 1132.

[116] Regarding those accompanying remedies see par 0above. Regarding the reliability of the remedies for a surety see par 0above.

suretyship by the mother company of the principal debtor backing up the claim for reimbursement).[117]

This is in line with commercial practise: as mentioned before, guarantors, in contrast to sureties, look only at the credit of the principal debtor when deciding whether to issue a guarantee and do not rely on the underlying transaction.[118] Because only the principal debtor's creditworthiness is the basis for this decision the same criteria apply as in a request for a loan.[119] Thus the request is either in accordance with the line of credit granted to the principal debtor by the guarantor, or the principal debtor must furnish collaterals (such as mortgages, suretyships or assignment of claims) covering the maximum amount of the demand guarantee. Just as a lender might have difficulties to be repaid, the guarantor might face problems to be reimbursed: the line of credit might turn out to be too generous or the collaterals of insufficient value. This, however, is a risk assumed by the demand guarantor.

The mere existence of a reliable remedy in law is not, however, able to change this: the guarantor must also be sure that this remedy is economically reliable. So, even if the benefit of cession of actions were accompanied by the claims compensating for the absence of the *exceptio cedendarum actionum* and the limitation to the backed-up claim (and the remedies flowing from the benefit of cession of actions were therefore legally reliable), it would further be necessary for the guarantor to investigate the economical soundness of these remedies in the given situation before he could claim that he did not rely merely on the principal debtor's creditworthiness. This would have the unfortunate result of requiring the guarantor to investigate the underlying transaction. One of the main benefits of guarantees (and therewith the reason for their relatively low cost), however, is that the guarantor does not need to investigate the underlying transaction but concerns himself solely with the creditworthiness of the principal debtor and the checking of documents.[120]

Hence, even in the event of the benefit of cession of actions being accompanied by claims compensating for the inapplicability of the limitation to the backed-up claim and the *exceptio cedendarum actionum*, the guarantor would only be able to argue that he has relied on these remedies if he has investigated the underlying transaction (that is that he has checked that the

[117] An example of indemnity provided by the mother company can be found in *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd* (n 48). It must be admitted, however, that the same would hold true if the surety would acquire advantages by means of the benefit of cession of actions that accrued after the time he bound himself, for example by virtue of a suretyship or mortgage furnished thereafter. There is, however, no authority on this point. See Forsyth/Pretorius (n 13) 148 who favour their inclusion. Stressing that subrogation is not based on reliance but unjust enrichment: American Law Institute (n 103) §27 Comment g. This does not, however, render this argument invalid as it is not one of legal principle but legal policy.

[118] See par 3 3 above.

[119] Dolan (n 57) 824 et seqq with further references.

[120] Avidon (n 43) 130.

backed-up claim as well as any supporting securities are economically reliable and the beneficiary would be able to meet a claim for repayment). This, however, would impact negatively on the relatively low cost of the demand guarantee since the cost of the investigation would be charged to the applicant. In the absence of such an investigation the guarantor necessarily accepts the risk that they may not be reliable.

5 4 <u>Efficiency</u>

Economic efficiency speaks against allowing to the guarantor the benefit of cession of actions alone (that is without the concomitant claims against the beneficiary referred to above).[121] This is so because whether or not the guarantor will enjoy the advantages of the benefit is completely arbitrary; they may fall apart before they are ceded to him (for example due to the creditor releasing co-debtors or sureties). The guarantor, moreover, cannot influence this decision of the creditor, nor, should it occur, is he compensated for its detrimental effect on his position. Hence he cannot take these advantages into account in good conscience when deciding whether or not to issue the demand guarantee or in determining the cost thereof.

The effect on other providers of securities, for example sureties, on the other hand, is far-reaching: in case the guarantor has no recourse against them, sureties of the backed-up claim can, from an economical point of view, deduct the amount of the demand guarantee from the backed-up claim in calculating their own risk as they can force the creditor to make use of such a security. If they nevertheless pay the backed-up claim, they are, due to the benefit of cession of actions, entitled to an assignment of the demand guarantee.[122] If the demand guarantor is entitled to such recourse, however, the other providers of securities face the risk of having to pay their aliquot share of the overall amount.

Hence, in the event of the guarantor being granted the benefit of cession of actions, the debtor will find it more difficult to obtain other securities, without it becoming easier for him to obtain a demand guarantee.

In the event of the benefit of cession of actions being accompanied by the concomitant claims, however, the guarantor would, by and large, be able to rely on the additional securities and would therefore be able to take them into account when deciding whether or not to issue the guarantee. The security so would make it easier to obtain the guarantee. Thus, in this situation, the debtor would, at least to some extent, be compensated for his difficulties to obtain alternative securities. Yet again the prerequisite is that the guarantor will have to investigate the underlying

[121] Regarding those concomitant claims see par 0above.

[122] See par 2 3 above, especially n 34.

transaction which would impact significantly upon the cost-effectiveness of the guarantee.[123] It is doubtful whether the additional security would outweigh these costs and whether guarantors would be willing to become involved in the underlying transactions in this manner.

5 5 Unjust enrichment

The underlying reason for applying the benefit of cession of actions is to allocate the burden of the underlying obligation equitably between the parties involved and thereby to prevent the unjust enrichment of one or some of them.

One might argue that it is necessary to apply the benefit of cession of actions to ensure that the principal debtor ultimately discharges his obligation.[124] Technically this is correct: if the guarantor pays the demanded sum and does not have the benefit of cession of actions, the principal debtor is relieved of his obligation towards the beneficiary to the extent of the payment. It is replaced, however, by an obligation of the principal debtor to reimburse the guarantor, directly if the principal debtor himself applied for the guarantee, or indirectly in the event of the principal debtor and applicant being different parties (the applicant must reimburse the guarantor and the principal debtor the applicant).[125] Although the obligation of the principal debtor to reimburse will probably differ in some respects from that arising from the underlying obligation, in substance it will be much the same. Regarded in this light there is no real risk of unjust enrichment in favour of the principal debtor even without the application of the benefit of cession of actions.

The view that it is necessary to uphold the backed-up claim by granting the benefit of cession of actions to prevent unjust enrichment goes further than placing the burden to pay on the principal debtor: it allocates the risk of the insolvency of the principal debtor. Whether guarantors and other participants in the underlying transaction are liable on the same level and should therefore bear the risk pro rata, however, is a quite distinct question. While there is no doubt regarding the principal debtor´s ultimate responsibility to bear the burden of the underlying obligation one might argue that the independent, and therefore exposed, nature of a demand guarantee provides justification for holding the guarantor primarily liable for this risk, as in the case of a cash depositor.[126] The argument that this amounts to an unjust enrichment of the other

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[123] See par 5 3 above, especially n 120.

[124] Förster (n 32) 452; Boss (n 32) 1132. Regarding this obligation see par 4 2 above.

[125] The claims would be based on the contract of mandate or, in the absence thereof, on the *actio mandati* or *actio negotiorum gestorum* analogous to the situation of a suretyship or, as a last resort, on unjust enrichment. Regarding the *actio mandati* and *actio negotiorum gestorum* in the context of suretyship: Henning/Mould (n 13) par 302.

[126] *Morgan Creek Residential v Earl S KEMP et al* 63 Cal Rptr 3d 232 (CalCtApp 2007) 240-241, 244. There are, however, cases in which this argument is not persuasive, namely when two demand guarantees are involved.

participants in the underlying transaction makes for circular reasoning.

5 6 Finality

The principle of independence is not only the basis for "pay now, argue later" but also for the concept of finality. In accordance with this concept the guarantor shall not be entitled to claim repayment on grounds other than those which would have entitled him to refuse payment in the first place.[127] One purpose of the principle is that a dispute regarding the underlying transaction can be solved between the parties thereto without the guarantor becoming part of the dispute or having to concern himself with it.[128]

So viewed the claims for repayment against the beneficiary to compensate for the inapplicability of the *exceptio* and the limitation principle would be a blunt attack on the independence principle. In effect they link the guarantee to the underlying transaction. This is the case because although they are in conformity with the "pay now, argue later" principle, they merely postpone the time upon which the guarantor is drawn into the underlying dispute. If, for example, in a construction guarantee, the employer-beneficiary calls up the guarantee on the basis of the principal debtor (contractor) being in default of the construction contract, and the guarantor pays out, the question whether the guarantor has any resultant claim against the beneficiary would be dependent upon whether the contractor was in fact in default. The guarantor, in this manner, is accordingly drawn into the dispute between the principal debtor and the beneficiary.

As other securities of the backed-up claim (such as a contractor´s lien securing his claim for payment, which claim is also backed-up by the guarantor) are often closely related to the underlying transaction, the question whether the guarantor would have a claim for repayment against the beneficiary compensating him for the absence of the *exceptio,* would also involve the guarantor in the underlying transaction.

The benefit of cession of actions alone, on the other hand, is no basis for a regress against the beneficiary and therefore would not technically violate finality. Nevertheless it affects the aim of the principle of independence to contain a potential controversy concerning the underlying transaction to the involved parties because guarantors will subsequently rely on claims resulting from this transaction.[129]

[127] Byrne (n 7) §71:3. See in similar vein Habersack (n 45) Vor §765 par 27-28; Canaris (n 46) par 1142; Larenz/Canaris (n 2) 244; Von Marschall (n 3) 40; Bertrams (n 1) 2.

[128] Ibid.

[129] See in similar vein Byrne (n 7) §71:4. Regarding this aim see n 127.

Although the parties have a strong and reasonable interest in this finality aspect of independence, one should not overestimate its importance: the parties would face the same detriment in case one of them would cede its rights to a third party as so often happens in modern commerce.

Finality, however, also has another effect: since it grants the right to repayment to the principal debtor, the creditor can, where applicable, defend himself against the claim for repayment based on other aspects of the underlying transaction (for example a right of retention).[130] If, however, the claim for repayment would originate in the guarantor, these defences would not be available to the creditor against this claim and would therefore endanger the aim of "pay now, argue later" since the creditor might be obliged to repay the amount before the dispute regarding the underlying relationship is settled.[131] It also shows that the position of a beneficiary of a demand guarantee governed by such a repayment-regime would be less beneficial than having access to a cash deposit. This state of affairs would hold the risk that the economically inefficient cash deposit could come back into play.[132]

5 7 Risk of blurring the principle of independence

As is evident from the much criticized judgement of the South African Supreme Court of Appeal in the *Dormell* case and its aftermath, an exception to the principle of independence, as limited as it might be formulated, may lead guarantors to refuse payment, and lead some courts to allow defences put forward by guarantors.[133]

In the event of claims against the beneficiary to compensate for the inapplicability of the *exceptio* and the limitation principle were granted, there would be the risk that guarantors as well as courts might not consequently stick to the requirement of full satisfaction of the demand guarantee and the backed-up claim. The most likely argument for disregarding this vital requirement would once again be that the beneficiary would have to repay the money on the spot in any event.[134]

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[130] Canaris (n 46) par 1142.

[131] Ibid. Pleyer (n 3) 19-20 asserts that such claims would go against the very idea of such guarantees although it is not clear on what aspect of finality he bases this statement. With regard to the claim compensating the guarantor for the absence of the limitation principle this could be solved, however, by a derivative claim. This is by granting it to the principal debtor as first step and assigning it to the guarantor as second step - as in the US. Regarding the situation in the United States see par 3 5 3 above, especially n 81. Regarding a possible way of implementation in South Africa see par 3 5 2 above, especially n 76.

[132] Stressing the importance of granting the beneficiary of a guarantee the same benefits as a cash deposit would do: Pleyer (n 3) 7.

[133] *Dormell* (n 74). Regarding these problems: *Coface* (n 48) par 24; Dolan (n 57) 803 et seqq. Sceptical: McCormack/Ward (n 32) 140-142; Boss (n 32) 1122-1123 and 1127.

[134] Dolan (n 57) 806 et seqq.

Due merely to the fact that any risk of a guarantor refusing to pay with reference to the underlying transaction endangers the object of the demand guarantee, this should be taken very seriously.[135]

5 8 Harmonisation

In most countries the question whether the guarantor should be able to make use of the backed-up claim after discharging it, seems not to be clearly settled. In England this issue is rarely discussed and there seems to be no authority in point.[136] In Germany scholars have given some attention to it, but they are divided, and there is no case law directly in point.[137] Even in the United States, where scholars as well as courts and the legislature have given the matter significant attention, the position is still unclear. Where § 5-117 of the Uniform Commercial Code, which expressly acknowledges the applicability of subrogation to letters of credit, applies, it remains unclear whether subrogation should only be available in the event of equity favouring the individual case, or whether considerations of equity should only prevent its application in exceptional circumstances (which would make subrogation available on a very large scale).[138] The position becomes even more uncertain in cases where the Bankruptcy Code comes into play.[139]

Thus, there is no international settled standard to which South African law could revert, as inviting as this would be in a legal question so closely connected to international trade.[140]

5 9 Conclusion

The application of the benefit of cession of actions to demand guarantees is not persuasive in the absence of the guarantor also acquiring claims against the beneficiary to compensate for the inapplicability of the *exceptio* and the limitation principle, as these claims are necessary to secure

[135] Dolan (n 57) 805 et seqq.

[136] *Ibrahim v Barclays Bank plc* (2011) EWHC 1897 (Ch) par 136-137; Chitty *Chitty on Contracts* Volume 2: Specific Contracts (2012) par 34-500; McCormack/Ward (n 32) 121 and 135. *Alliance Bank JSC v Aquanta Corporation and Others* (2012) 1 Lloyd's Rep 181 (Comm) does not deal with independent guarantees but states at par 21 that subrogation is (even in the classical fields of its application) not yet settled.

[137] n 92.

[138] Dolan (n 57) 789 et seqq argues strongly for the first although case law seems to indicate to opposite. Regarding the requirement of equity see also McCormack/Ward (n 32) 140-141; *Tudor Development* (n 51) majority judgment 363 and indorsed minority judgment 365, 369, 371; Byrne (n 7) §71:6; Dolan (n 114) 229 et seqq, especially 231 and 234 et seqq, (n 57) 789 et seqq especially, 811 et seqq and 833; McCullough *Letters of credit* (February 2014) par 4-307; White (n 35) 59-60.

[139] Byrne (n 7) §71:14; Dolan (n 57) 815 et seqq.

[140] Förster (n 32) 449 perceives a strong tendency in favour of such a recourse.

the guarantor's position. In case only the benefit of cession of actions were granted to the guarantor, he could neither influence the continuity of its advantages nor would he be compensated for their disappearance. Hence the guarantor would not be able to rely on them and this remedy alone would be arbitrary and economically inefficient.

Adding the accompanying claims against the beneficiary to the benefit, on the other hand, would only make sense if the guarantor were to investigate the underlying contract. This would run counter to one of the perceived established benefits of demand guarantees namely that the guarantor does not have to concern himself with the underlying contract. It also entails the risk of blurring the principle of independence and endangers the aim of the demand guarantee to provide the beneficiary with the proceeds of the guarantee during the dispute concerning the underlying relationship.

Moreover, irrespective of whether the benefit is bolstered by the accompanying claims against the beneficiary, conflict resolution is likely to become considerably more complex as the guarantor would become involved in the underlying transaction.

For these reasons, irrespective of whether the benefit is bolstered by the accompanying claims, it is suggested that it is not desirable to extend the benefit of cession of actions to demand guarantees.

In a particular case there may be special circumstances where these problems are not relevant, or where the benefits of a right to cession are so powerful that the parties are willing to accept them. In these rare instances, however, they are free to adapt the express terms of their contracts accordingly.

6 Conclusion

On a level of legal principle the benefit of cession of actions could conceivably be made applicable to demand guarantees. It is suggested, however, in light of the contractual relationships between the parties and the contractual implementation of the independence principle, that this would require good reasons.

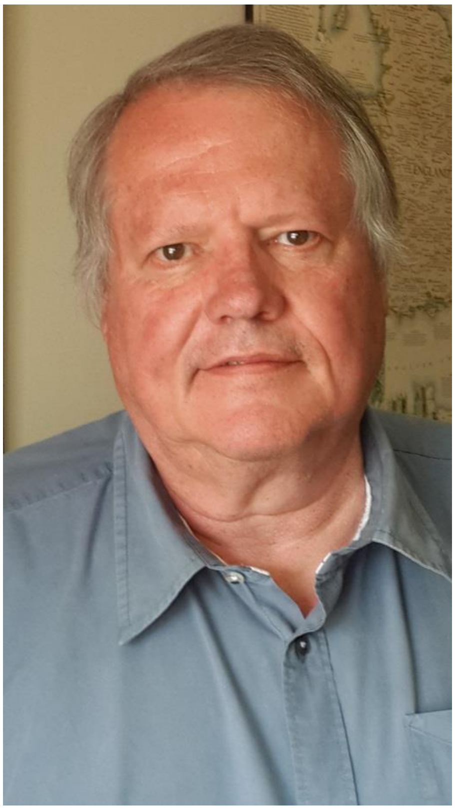
The aim of providing the guarantor with some recourse against debtors and providers of securities of the backed-up claim might conceivably be worth pursuing, but this is, to a great extent, open to doubt. It is important to note, however, that the benefit of cession of actions alone cannot ensure such recourse: it would need to be bolstered by additional rights in compensation for the inapplicability of the *exceptio* and the limitation principle. It is submitted that while the benefit of such recourse might justify the relatively small interference of the underlying transaction flowing from the benefit of cession of actions alone, it does not provide sufficient cause for the severe interference which would flow from the concomitant claims.

For these reasons *the* benefit of cession of actions should not be granted to demand guarantors.

Part I: general topics

Prof JT (Jopie) Pretorius (Chairperson)

Jopie Pretorius obtained the B-Iuris degree from the University of Pretoria in 1973 and the LLB degree from the University of Natal (Pietermaritzburg) in 1975. After serving his articles for two years he was admitted in 1978 as an attorney of the Supreme Court of South Africa and in the same year obtained the LLM degree from the University of Cape Town. He obtained a second LLM degree in company law from the University of London (King's College) in 1979. From 1981-1985 he was a senior lecturer in the School of Law at the University of the Witwatersrand. He was appointed associate professor in the Department of Mercantile Law at the University of South Africa as from the 1st January 1986. In the same year he obtained the LLD degree from the Rand Afrikaans University. Professor Pretorius was promoted to professor of law in the Department of Mercantile Law at the University of South Africa on the 1st October 1986. He is the co-author of more than 20 text-books and the author and co-author of more than 100 articles in legal journals. He served two terms as the academic representative on the Unisa Council. He is rated an 'internationally acclaimed researcher' by the National Research Foundation.



Prof Sarel du Toit

Sarel du Toit is Professor of Law at the Faculty of Law, North-West University, where he currently teaches Banking Law and Company Law and is an assistant editor of the *Potchefstroom Electronic Law Journal*. His research interests include law of negotiable instruments, banking law, financial law and property law. In 2008 he delivered his inaugural address dealing with "The Dematerialisation of Money and the Lingering Influence of the Law of Things" at the University of Johannesburg, and in 2013 a second inaugural address at the North-West University, entitled "The Juridical Nature of Money: Shifting Matrices and Paradigms". He is co-author of *Malan on Bills of Exchange, Cheques and Promissory Notes in South African Law* 5th ed (2009). He studied at the Rand Afrikaans University, where he obtained his BA and LLB degrees *cum laude*. He completed his LLD thesis, also at RAU, under the supervision of Judge FR Malan.

Dr Marc Leistner

Marc Leistner is the Deputy Head of the European Investment Bank's Regional Representation for Southern Africa and Indian Ocean, based in Pretoria.

Marc has been with the European Investment Bank (EIB) Group since 1997 and until the end of 2012 was based at the Group's head office in Luxembourg. Initially, he joined the European Investment Fund (EIF), where he was part of the team working on portfolio guarantees within the European Union. In 2001, he joned the EIB as the responsible loan officer for operations in Russia and later became the Deputy Head of Division for operations in Russia and Eastern Neighbours. In 2010, Marc transferred to the Southern Africa and Indian Ocean Division as the loan officer responsible for Zambia, Malawi and Botswana, working mainly on infrastructure development. In 2011, Marc's responsibilities expanded to that of Deputy Head of Division. He took up his current position in January 2013.

Mr Steven Gamble

Steven (English Solicitor / Hong Kong SAR, China Solicitor) heads up Norton Rose Fulbright South Africa's English law banking and finance team. He is the Chairman of the Loan Market Association (LMA)'s Africa Group and is the former Chairman of the African Loan Market Association (ALMA), prior to its integration with the LMA. He is also a member of the LMA's English Law Developing Markets Documentation Working Group. He is currently based in Harare with Gill, Godlonton & Gerrans (**3Gs**) as part of strategic alliance with 3Gs in Zimbabwe. Before joining the firm's Johannesburg office, Steven spent time in the firm's London, Singapore and Hong Kong offices before heading up the firm's English law banking and finance practice in Bangkok in 2005 and Johannesburg in 2007. He has a wealth of experience in advising international and domestic banks and companies in relation to project finance, acquisition finance, mezzanine and other structured finance and general commercial transactions, with a particular focus on cross-border and emerging markets work.

<u>Prof Thabo Legwaila</u>

Prof Thabo Legwaila is a Professor in the Mercantile Law Department and teaches Tax Law. He holds the following qualifications: B Iuris from the University of Venda, an LLB and an LLM from Wits University, a Postgraduate Diploma in Tax Law and an LLM from the University of Cape Town and an LLD from the University of Pretoria. Prof Legwaila started his career as a Lecturer and advanced to Senior Lecturer in the Mercantile Law Department at the University of Stellenbosch. He was later invited to Harvard University where he spent time as a Research Fellow in the Harvard University International Tax Program. He subsequently moved into tax consultancy at KPMG and later Ernst & Young. In 2006 Prof Legwaila joined the South African National Treasury as a Director for Business Tax where his role was to develop the South African business tax policy as well as manage general tax legislative amendments and specific business law amendments. In 2011 he joined Citibank as Head of Tax for the Africa division. Prof Legwaila published widely in Tax Law both in accredited and peer reviewed journals as well as in magazines and newsletters. He also recently co-authored the tax textbook *Tax Law: An Introduction* which is specifically intended at explaining “a vast terrain of tax law to students”.

Ms Desima Beukes

Desima Beukes graduated from the Universities of Pretoria and UNISA, and holds diplomas from the Universities of Cape Town and Johannesburg. She was formerly a director of Van der Spuy Inc, Cape Town, a position she held for almost 20 years. She is currently a consultant with the same firm. She specialises primarily in banking law. In her leisure time she is a student in the fine arts.

Part II: company law

Prof AH (Andreas) van Wyk (chairperson)

Andreas van Wyk graduated *cum laude* with the degrees of BA (Law) and LLB from Stellenbosch University. Following postgraduate studies in Germany and France, he was awarded the degree of doctor of laws *cum laude* by the University of Leiden in the Netherlands in 1976. In March 1997 an honorary doctorate in law was awarded to him by the University of Leuven in Belgium. He received another such degree from the University of Stellenbosch in 2014.

Professor van Wyk's academic career led him to become a professor in private and commercial Law and, subsequently, dean of the Law Faculty at Stellenbosch University. From 1992 – 2001 he served as the university's Rector and Vice-Chancellor. As a legal academic Andreas van Wyk was the author of three works on South African law and of more than 30 learned articles. He was also involved with the drafting of important legislation, particularly the Divorce Act of 1979 and the Matrimonial Property Act of 1984, which conferred equal rights on married women.

Between 1984 and 1987 he was director-general of the national Department of Constitutional Development and Planning. In this capacity he was responsible for many reforms, in particular the abolition of the pass laws and the introduction of full ownership of land for black South Africans, and the preparatory work for negotiations aimed at a new South African constitution.

Since 2002 he has been lecturing in and advising on advanced company law at Stellenbosch and elsewhere, specialising in the legal aspects of corporate governance and the reform of corporate law. He also served on a number of company boards, ranging from Distillers Corporation to the Victoria & Alfred Waterfront. He had a close involvement with Old Mutual Life Assurance (South Africa) Limited where he served on the board for nearly 20 years. During the global financial crisis from 2008 to 2009 he served as chairman of the board of Old Mutual South Africa.

His other interests include international politics and economics, classical music, and 20th century art. In December 2007 he received a B Phil degree in Ancient History *cum laude* from Stellenbosch University. Prof van Wyk speaks Afrikaans, Dutch, German, English, French and Spanish, and reads Italian, Latin, Portuguese and Swedish.

Prof Kathleen van der Linde

Kathleen van der Linde is professor and head of the Department of Mercantile Law at the University of Johannesburg. She teaches company law, corporate finance law, securities and financial markets law and some corporate insolvency law to LLM students. Her primary research interests are in corporate finance law and corporate insolvency law. She is a co-author of Sharrock, Van der Linde and Smith *Hockly's Insolvency Law* (Juta). She has contributed the South African chapters to Faber, Vermunt, Kilborn and Richter (eds) *Commencement of Insolvency Proceedings* (2012) and Faber, Vermunt, Kilborn and Van der Linde (eds) *Treatment of Contracts in Insolvency* (2013) in the Oxford International and Comparative Insolvency Law series, published by OUP in association with the Business & Law Research Centre of the Radboud University Nijmegen. She recently contributed to a book on the financing of company group restructurings about to be published by OUP upon the initiative of the Insolvency Section of the International Bar Association.

Kathleen presents short learning programmes in the field of Corporate Law at the University of Johannesburg, and is a co-presenter of the programme in Advanced Company Law and Securities Law of the Centre for Business Law at the University of South Africa. She has presented training on the new Companies Act to several law firms and businesses.

Prof Natania Locke

Prof Natania Locke joined the university in January 2015 as a Professor of Mercantile Law. She teaches company law, corporate finance law and financial markets & securities regulation in the LLM programme in Corporate Law and is also currently developing an LLM module in financial regulation. She was a Professor of Commercial Law at the University of the Witwatersrand from July 2010, and an Associate Professor at the University of South Africa. Prof Locke's research interests centre on corporate debt. Her LLD thesis, *Aspects of Traditional Securitisation in South African Law*, completed under the supervision of Michele Havenga and Susan Scott, is currently the only comprehensive work on this form of financing in South African law. She publishes in the fields of corporate governance, specifically transparency and disclosure, corporate finance and financial regulation.

Qualifications

BA LLB LLM (RAU) LLD (Unisa)

Part III: financial regulation

Prof Willem Krüger (chairperson)

Willem Krüger joined Nedbank's Legal Department in 1975, and was appointed Chief Legal Adviser in 1993, a position which he held until his retirement in 2012. During the course of his career he also acted as Nedbank's Group Secretary, and had management responsibility for, inter alia, the Nedbank Group's Corporate Insurance programme, and its Editorial and Language Services .

He studied at Stellenbosch (BA (Law)), UNISA (B Proc and LLB) and UJ (Diploma in Advanced Banking). He is an Honorary Professor in Banking Law at UNISA and a past member of the Standing Advisory Committee on the Revision of the Bank's Act.

Prof Thomas MJ Möllers

Prof Möllers was born in Mainz, Germany in 1962, has been married since 1992, and has 3 children. He studied law at the Universities of Mainz, Dijon, California (at Berkeley), Florence and Munich.

In 1996 he was appointed full Professor of Law at the University of Augsburg (Chair for Civil Law, Economic Law, European Law, Conflicts of Law and Comparative Law) and Director of the Centre for European Legal Studies (CELOS). Since 2008 he has held the Jean-Monnet-Chair ad personam.

In 2009 he became Member of the Board of the Foundation “Geld und Währung” (Money and Currency) of the Deutsche Bundesbank (German Federal Bank), and since 2010 has been involved with the Foundation of the Database on German and European Economic Law (http://www.kapitalmarkt-im-internet.eu) to visualize the influence of European Law on national law and to promote the transparency of the legislative process.

He has been a Visiting Professor of Law at various universities in different countries, e.g. the China University of Political Science and Law (CUPL) in Beijing, the George Washington University in Washington D.C., USA, the University of Pittsburgh, USA and the University of Sydney, Australia.

He has been instrumental in establishing cooperation between the Augsburg Faculty of Law with universities in China (Beijing and Chongqing), USA (Chapel Hill, Chicago, Malibu, Washington, Santa Clara) and South Africa (Stellenbosch and Cape Town).

Prof Möllers has more than 300 publications with the academic emphasis on German and European Economic Law (Capital Market Law, Company Law and Unfair Competition Law).

Prof Benjamin Geva

Benjamin Geva is a Professor of Law at Osgoode Hall Law School in Toronto. He specializes in commercial, financial and banking law, particularly in payment and credit instruments, fund transfers, electronic banking, central banking, and the regulation of the payment system. He obtained his LLB (cum laude) at the Hebrew University of Jerusalem (1970) and his LLM and SJD at Harvard, and was admitted to the Ontario Bar in 1982. He has been on the Osgoode faculty since 1977. He practised with Blake, Cassels and Graydon in Toronto and is now counsel with Torys where he is a member of the Payments and Cards Practice Group.

He was awarded prestigious competitive grants among others by the Social Sciences and Humanities Research Council of Canada and the Foundation of Legal Research of the Canadian Bar Association and has written extensively in his areas of expertise, including a monograph on Financing Consumer Sales and Product Defences in Canada and the US (Toronto: Carswell, 1984), a treatise on the Law of Electronic Funds Transfer (New York: Matthew Bender, 1992, kept current with annual updates, since 1997 with contributors), a comparative law text on Bank Collections and Payment Transactions (Oxford: OUP, 2001), and a monograph on The Payment Order of Antiquity and the Middle Ages — A Legal History (Oxford and Oregon: Hart Publishing, 2011). As well, he is the founding editor in chief of the Banking and Finance Law Review (BFLR).

He held visiting positions, in the United States at the University of Chicago, the University of Illinois, the University of Utah and Northwestern University as well as in the summer program of Duke University in Hong Kong; in Israel at Tel Aviv University; in Australia in Monash, Deakin and Melbourne Universities; in Singapore at the National University of Singapore, in Germany in the University of Hamburg, and in France at the faculté de droit et de science politique d'Aix-Marseille. He has been a Visitor at the law faculties of Oxford and Cambridge Universities in England and at the Max-Planck Institute for Comparative and Private International Law, Hamburg, Germany, as well as a Senior Global Research Fellow, at the Hauser Global Visitors Program, New York University School of Law.

Under the IMF technical assistance program he has advised and drafted key financial sector and payment systems legislation for the authorities of several countries, particularly, on missions for Bosnia and Herzegovina, Kosovo, Haiti, Yugoslavia (Serbia), Cambodia, Afghanistan, Timor-Leste, and Sri Lanka. Particularly in Canada but also in the United States and in the international arena he has been on legislative committees and drafting working groups in the areas of personal property security, securities transfers, letters of credits & independent guarantees, and payment law.

His current research is on bank money, bank deposits, negotiable instruments & funds transfers, and payment and settlement systems.

Prof Angela Itzikowitz

Professor Angela Itzikowitz is an executive at ENSafrica in the banking and finance department. She specialises in banking and financial market regulation, including finance and regulatory reform, card and related electronic payment instruments, derivatives, loan agreements, collective investment schemes, insurance, money laundering and debt origination and securitisation.

She has done a significant amount of work in African countries such as Uganda, Kenya and Zambia including regulatory law reform through capacity building projects. More recently she drafted and advised on the Finance and Development Protocol for SADC in her capacity as a senior legal expert. She has also advised the World Bank on deposit insurance and bank insolvencies.

Angela has participated in a number of financial market initiatives in Asia, in collaboration with colleagues from Beijing, Shanghai, Hong Kong and India. She also acts for a number of European banks, asset managers and investment advisors.

Angela is also a professor in Banking and Financial Markets Law at the University of the Witwatersrand and teaches at Queen Mary College, the University of London on Legal Aspects of International Finance. She is the author of the Law of South Africa (LAWSA) Banking and Financial Markets, has co-authored a number of books and has published numerous articles in local and foreign journals.

She is a member of the Board of International Scholars, London Institute of Banking and Finance and is a Professorial Fellow at the Asian Institute of International Financial Law, University of Hong Kong. She is also a visiting Professor at Shanghai University of Finance and Economics and Peking University, and is the recipient of a number of international fellowships and awards and sits on a number of advisory committees and company boards.

Angela was recently recognised as a leading lawyer by the following reputable rating agencies and their publications: Chambers and Partners Global Guide to the World's Leading Lawyers 2015, 2014, 2013 – Banking and Finance (South Africa); Best Lawyers – Banking and Finance (South Africa)

Angela is fluent in English, Afrikaans and German and speaks South Sotho and Mandarin.

Qualifications: BA LLB (Stellenbosch); Program of Instruction for Lawyers (Harvard); Legal Aspects of International Finance (Banking and Finance Law Unit, Queen Mary College, University of London).

Prof Daleen Millard

Daleen Millard obtained the LLD degree from the University of Johannesburg in 2005/06. She also obtained the degrees BIUR, LLB and LLM from the University of Pretoria and a diploma in Insolvency Law from the Assoiaction of Insolvency Law Practitioners.

After starting her career as an administrative clerk in the Department of Justice in 1991, she proceeded to work as a claims handler at the Multilateral Motor Vehicle Accident Fund (as it then was). She started her academic career with Vista University, Mamelodi and was then appointed as senior lecturer in the Department of Mercantile Law, University of Pretoria. She is currently employed as a professor of law in the Department of Private Law, University of Johannesburg and she specialises in Law of Delict, Law of Damages and Insurance Law. She lectures Law of Delict to LLB students and Interpretation of Contracts to LLM students. She had practised as an advocate and had been a full member of the Pretoria Society of Advocates and when time permits, she drafts legal opinions.

She has presented papers at several national and international conferences. She is the author and co-author of various national and international articles in accredited journals. She is a member of the International Insurance Law Association.

She is the author of the student text *Modern Insurance Law in South Africa* (Juta, Cape Town) and the co-author of *The FAIS Act Explained* (LexisNexis Butterworths, Durban) with Wendy Hattingh. She was recently awarded the prize for the best contribution in the Journal for Contemporary Roman-Dutch Law for 2014 for her article entitled: “Through the looking glass: Fairness in insurance contracts – A caucus race?” by the Vereniging Hugo de Groot.

Part IV: the National Credit Act

Prof JM (Jannie) Otto (chairperson)

Prof Otto was appointed as Professor of Mercantile Law at the Rand Afrikaans University on 1 October 1981. He served the RAU, and later UJ, in various capacities as Dean of Student Affairs (1987-1989), House Father of Benjemijn Ladies' Residence (1995-2001) and Executive Dean of the Faculty of Law (2004-2008). He served on numerous university committees, including the University Council. He was awarded Colours twice by the university for, respectively, leadership and academic achievements. He has taught a wide spectrum of subjects during his career in the broad fields of Commercial and Private Law to undergraduate law and commerce students and postgraduate law students. He currently teaches, among others, the module Credit Law in the LLM in Banking Law. He has done extensive research in a large number of European countries and in Great Britain. Professor Otto's long list of publications has often been cited and quoted over the years by judges in reported court cases, by counsel in heads of argument and by other legal writers in theses, books and articles.

Qualifications

BA LLB (cum laude) LLD (Pret)

Professional Bodies

Advocate of the High Court of South Africa

Prof Corlia van Heerden

Corlia van Heerden holds the Barclays Africa Chair in Banking Law in Africa at the University of Pretoria. She is a professor in the Department of Mercantile Law. She is also a practising attorney and a qualified conveyancer. She has published a number of articles, many of them on aspects of the National Credit Act and is also a co-author of the *Guide to the National Credit Act* (Lexis Nexis).

Dr Stéfan Renke

Stéfan Renke is a senior lecturer in the Department of Mercantile Law, University of Pretoria. He specialises in consumer protection law (more in particular consumer credit law) and presents courses on undergraduate and postgraduate level in this field. He also presents lectures in this area at the University of Pretoria Law School for candidate attorneys. Stéfan has co-presented seminars and short courses on the National Credit Act 34 of 2005 and wrote various publications on the subject. He has presented papers at national and international conferences and is a member of the International Association of Consumer Law. Stéfan completed his doctorate entitled "An evaluation of debt prevention measures in terms of the National Credit Act 34 of 2005". Stéfan is also an admitted attorney.

Prof GTS (Sieg) Eiselen

Sieg Eiselen is professor in Private Law at the University of South Africa, Pretoria. He lectures in general contract law, unjustified enrichment law, international trade law and information technology law. He holds a doctorate of law in contract law from the University of Potchefstroom. He is an NRF B rated researcher. He has a litigation practice in commercial law and has been a member of the Johannesburg Bar since 1999. He is co-author with Albert Kritzer of Pace Law School, New York, of the *International Contract Manual Volumes IV and V* (Thomson West). He is also co-author with Dana van der Merwe, Anneliese Roos and Tana Pistorius of *Information Technology Law* (LexisNexis) and co-author with Tjakie Naudé *Commentary on the Consumer Protection Act* (2015 Juta). He has published widely on general South African contract law, unjustified enrichment law, international trade law and harmonisation, information technology law and consumer credit law.

Mr Alwyn Möller

Alwyn Möller is a practising advocate and member of the Cape Bar. He regularly advises and represents clients in a broad field of commercial law, including the law of contract, law of property and sale, sectional title schemes, administrative law, law of insolvency and liquidation, law of trusts, insurance law, and company law.

He has significant experience in providing legal advice to credit providers on consumer credit, credit bureaux and the use and dissemination of consumer credit information under the relevant regulatory laws and private agreements, and advises on the structuring and formulation of credit products offered to consumers under the National Credit Act.

He further advises on, and formulates, products for credit providers to which the National Credit Act does not apply. He advises on the configuration of various credit product offerings, and on capital funding e.g. through cessions and/or discount sales of future debts. The litigation component of his practice includes matters in the fields of water law, environmental law and aspects of mineral law.

Part V: letters of credit and demand guarantees

Mr Anton du Randt (chairperson)

Anton is a litigation lawyer based in Johannesburg.

Anton represents clients, mainly audit firms, construction companies and insurance companies in professional liability disputes, insurance disputes and a variety of regulatory matters. He has been involved in a large number of high-profile disputes against audit firms, construction companies and insurers.

Anton obtained his LLB degree from the Nelson Mandela Metropolitan University (previously UPE) in 2005 and is fluent in English, Afrikaans and Xhosa. Anton is a member of the Law Societies of the Northern Provinces, and was named Law Student of the Year at the Nelson Mandela Metropolitan University in 2005. He has authored a number of articles on insurance aspects, guarantees, construction and related topics. He has presented at seminars on white-collar crime, professional liability, insurance, consumer protection, guarantees and construction and some aspects of the Road Traffic Act.

He is a director in the Professional Liability and Construction team and heads up the local guarantee focus group within the firm.

Prof Michelle Kelly-Louw

Professor Kelly-Louw holds a doctoral degree in international banking law. She has published widely in the fields of insolvency law, banking law and consumer credit law and her research has been cited with approval and quoted by the Constitutional Court and the Supreme Court of Appeal on several occasions. In 2008 she received the Unisa Principal's prize for excellence in research and a year later she received the Unisa Resilience in Research Award. In 2010 she received the SA Department of Science and Technology's award for Distinguished Young Woman Scientist (Academic Excellence in Social Sciences), in 2011 she received the Unisa Women's Forum 2011 Woman of the Year Award (Achievement), and in 2013 she received the Unisa Leadership in Research Women Award. Throughout her career she has been extensively involved in the drafting of legislation. For instance, she drafted the consequential amendments contained in the National Credit Act 34 of 2005, provided expert advice to the drafting team and also assisted with the drafting of the 2006 Regulations to this Act. For three years she served on the panel of legal experts (legislative drafting) for the SA National Treasury and the legal panel of the SA National Roads Agency Limited Property Portfolio. She was also a member of the Business South Africa's Task Group on Insolvency Law who investigated the proposed Unified Insolvency and Business Recovery Bill of 2003. She is the vice president of the *International Association of Consumer Law* and a member of various local and international law journals.

Mr Karl Marxen

Karl Marxen is a doctoral student, working on construction guarantees, at the Centre for Banking Law of the University of Johannesburg. He completed his undergraduate studies at the Hamburg University in Germany and the University of East Anglia in the United Kingdom. In 2012 he obtained the LLM degree in international trade law cum laude from the University of Stellenbosch. He has several publications in international journals recently focusing especially on international commercial law.

<u>Mr Frank Buchhöcker</u>

Frank Buchhöcker was born in 1988 and studied law at the Albert-Ludwigs University in Freiburg im Breisgau, Germany, focusing on commercial and company Law. He concluded his studies there in 2013 with the First State Examination in Law. Thereafter he took part in the masters´ program in International Trade Law at the University of Stellenbosch with a scholarship from the German Academic Exchange Service (DAAD), and obtained the LL.M. degree cum laude.

He was accepted as doctoral candidate in 2014 at the University of Bayreuth, Germany. His doctoral research deals with the Regulation of Related Party Transactions in the Law of the European Union, Germany and England. He is a research assistant to Professor Dr Jessica Schmidt LL.M. (Nottingham) at the Chair for Private Law, German, European and International Company and Capital Markets Law.

Centre for Banking Law

The Centre for Banking Law, housed in the Department of Mercantile Law of the University of Johannesburg aims to stimulate research in banking law by post-graduate teaching, publications, the building of partnerships and the hosting and arranging of conferences and workshops relating to banking law. In this latter respect its flagship is undoubtedly the Annual Banking Law Update – a conference with a proud history approaching four decades.

The current director of the Centre is Professor Charl Hugo who holds the degrees BA(Law) and LLB from the University of Pretoria, LLM from the University of South Africa and LLD from the University of Stellenbosch.

He qualified as an Attorney in 1985 after which he joined the lecturing staff of the Department of Mercantile Law of the University of Stellenbosch. He became a full professor in 1996, and chaired the Department for the period 2001 – 2004. During this period he achieved a C2 NRF rating.

In 2005 he did pupillage at the Cape Bar. He resigned and joined the Cape Bar after passing the Bar Exam, and practised full-time as an advocate at the Cape Bar from 2005 until 2012. During this period he continued lecturing at LLM level at the Universities of Stellenbosch, North West and KwaZulu Natal, and held appointments as extra-ordinary professor at the Universities of Stellenbosch and North West. In 2008 he qualified for accreditation by the ADR Group as Civil and Commercial Mediator, and became a member of the Equilore panel of mediators.

He was appointed by the University of Johannesburg as from January 2013 with the primary responsibility of teaching, researching and stimulating research in banking law, which, together with construction law, are his main fields of interest.

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