# Annual Banking Law Update 2016

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# Annual Banking Law Update 2016

*Recent Legal Developments of Special Interest to Banks*

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*Editor:* **Charl Hugo**

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*Annual Banking Law Update 2016*

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# Preface

The *Annual Banking Law Update* (ABLU™) has been running now for almost four decades. It was the brainchild of Professor Frans Malan, the banking-law doyen of South Africa who was later elevated to the bench, retired from the Supreme Court of Appeal in 2015 and now holds an appointment as visiting professor at the University of Johannesburg. It developed under the auspices of the Research Unit for Banking Law of the Rand Afrikaans University and, after the merger which gave birth to the University of Johannesburg, was later carried forward as the main activity of the Centre for Banking Law of the University of Johannesburg under the able leadership of my predecessor, Professor Sarel du Toit.

My own involvement with ABLU started in 1993 when Professor Malan invited me to present an update on letters of credit. Since that date, whether presenting an update or not, this event has been high on my priority list. For me, the value of ABLU did not, and still does not, lie all that much in the day of the event; the main drawcard has always been the ABLU bundle containing a wealth of professionally presented information far exceeding that which the authors could possibly share with the audience in the limited time to their disposal on the day. Many contributions were subsequently published in peer-reviewed journals, the ABLU bundle is routinely cited in legal writing, and even, on occasion, in our courts. Moreover, the library of the University of Johannesburg continually receives many requests for inter-library loans for ABLU bundles of the past.

Against this background I was very pleased when Juta & Co agreed to join hands with the Centre for Banking Law in producing this volume – which I am bold enough now to call the *ABLU Book 2016*. The *ABLU Book 2016* draws together research on various aspects of law of special interest to banks, namely: case law on companies of particular importance for lenders (with much on business rescue); bank failures and corporate governance of banks in Africa; a review of the fast growing South African case law on demand guarantees; traditional and developing trade finance instruments and methods (and the role of the International Chamber of Commerce in this regard); the banking ombud in the envisaged twin-peaks environment; VAT on financial services; reinstatement of credit agreements; the potential role of banks in relation to land-tenure information; and, finally, on the criminal law front, a comprehensive overview and critical analysis of theft by digital means and counterfeit card fraud.

In my relatively short experience of arranging ABLU I have been humbled by the meticulous academic work so many colleagues have put into their respective contributions, almost always, due to firm deadlines, under much pressure. In a sense, therefore, this book is to me, in the first place, a token of recognition of the large body of quality legal academic work contained in the ABLU bundles of the past, and, secondly, of course, also of the work represented in the *ABLU Book 2016*.

A special word of thanks is due to Linda van de Vijver, Juta's representative in this project. Her patience and professionalism was remarkable. It is my sincere hope that the *ABLU Book 2016* will be the first of a cooperative series between the Centre for Banking Law of the University of Johannesburg and Juta and Co Ltd.

Charl Hugo
Johannesburg
October 2016

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# An overview of recent company law cases that are of particular importance to lenders

NATANIA LOCKE*

## 1 *Introduction*

The interpretation of the Companies Act 71 of 2008 ("the act") continues to provide ample work for practitioners, academics and the bench. It has now been five years since the commencement of the act, which means that some of the more litigious issues are now reaching the supreme court of appeal for consideration. We still await a consolidated bankruptcy bill to see the light of day, which leaves many aspects of the business rescue procedure uncertain – as will be seen from the discussion below.

This contribution considers judgments delivered between May 2015 and September 2016 in the fields of company law and corporate insolvency law, which may be of interest to lenders. It does not attempt to be a comprehensive survey of case law.

## 2 *Representation of companies*

The well-publicised matter of *Makate v Vodacom (Pty) Ltd*[1] made it all the way to the constitutional court this year. The judgment is important for its interpretation of ostensible authority in South African law. The court was divided in this interpretation, with six judges concurring in the main judgment delivered by Jafta J and three in the concurring judgment delivered by Wallis AJ. For the reasons set out below, I am of the opinion that the concurring judgment is the soundest in law.

Makate was a junior employee in the finance department of Vodacom when he came up with the idea of the "please call me" function that is now widely in use on cellular phones. He originally shared his idea with his immediate superior, who advised him to share it with Vodacom's Director of Product Development and Management (Geissler). Makate alleged, and the trial court accepted his version, that he and Geissler agreed that if the product were technically feasible and were to be implemented he would receive remuneration for coming up with the idea. He testified that a figure of 15% of revenue was mooted, but that it was agreed that the chief executive officer of Vodacom would decide about the exact figure at a later stage. The chief executive officer at the time of the events was Alan Knott-Craig (Knott-Craig). Initial Vodacom documentation acknowledged that the idea came from Makate, but later Knott-Craig and Geissler disputed this.

Neither remuneration nor any attempt at negotiating remuneration was ever offered and this led to the litigation. Makate sought an order compelling Vodacom to negotiate reasonable remuneration as was agreed upon. In turn, Vodacom alleged that Geissler did not have the authority to bind it to the disputed agreement. Makate's claim relied on Geissler's ostensible authority and not on his actual

* Visiting professor, University of Johannesburg.

[1] 2016 4 SA 121 (CC).



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authority to bind Vodacom. This was not pleaded in replication and Vodacom argued that this was fatal to Makate's case. Additionally, it pleaded that Makate's claim had prescribed.

The court a quo held that ostensible authority is a form of estoppel, which had to be pleaded in replication.[2] Failure to do so was therefore fatal to Makate's case. It also held that the "debt" created by the alleged agreement had in fact prescribed. Neither that court nor the supreme court of appeal granted authority to appeal, but such authority was granted on a direct approach to the constitutional court.

Essentially, the main judgment held that ostensible authority and estoppel is not the same thing.[3] Its explanation goes as follows: estoppel is used when authority is alleged by a plaintiff and denied by defendant. The plaintiff must then raise estoppel in replication against the denial of authority.[4] Ostensible authority is interpreted as *actual* authority that comes about through the principal's representation that the person has authority.[5] As authority for this interpretation the majority relies on a sole sentence from the English decision *Hely-Hutchinson v Brayhead Ltd*:[6] "Ostensible or apparent authority is the authority of an agent as it appears to others." Based on this one sentence the main judgment held that the judgments of the supreme court of appeal in *NBS Bank Ltd*[7] and *South African Broadcasting Corporation*,[8] which both clearly held that ostensible authority is a form of estoppel, were decided incorrectly. The main judgment seems to take issue with the manner in which the requirement of a representation of authority by the principal was determined in especially the *NBS Bank Ltd* decision. There might be merit in this unease, but that does not change the character of what was given to the purported agent into actual authority.

The main judgment did not consider the extensive line of judgments in England and in the rest of the commonwealth jurisdictions that have consistently held ostensible authority to be a form of estoppel. In fact, the leading decision on this matter is the judgment of the House of Lords in *Armagas Ltd v Mundogas SA (The Ocean Frost)*.[9] In that judgment ostensible authority is expressly described as a form of estoppel.[10] It confirmed the judgment in *Freeman & Lockyer (A Firm) v Buckhurst Park Properties (Mangal) Ltd*,[11] which was decided before the *Hely-Hutchinson* decision in the same court and therefore binding authority of that decision against which it should be interpreted. This line of judgments are discussed in-depth in the concurring judgment,[12] which then comes to the conclusion (1) that ostensible authority is based on estoppel by representation[13] and (2) that there can be no possibility of actual authority when the authority is only ostensible.[14]

However, given the constitutional mandate of the courts to develop the common law, the more important part where the main judgment goes awry is that it never

[2] 2014 1 SA 191 (GP).
[3] par 44.
[4] par 45.
[5] par 46.
[6] 1968 1 QB 549 (CA) 583A – G.
[7] 2002 1 SA 396 (SCA).
[8] 2006 2 SA 217 (SCA).
[9] 1986 2 All ER 385 (HL). See also the concurring judgment at par 130.
[10] 389 – 390.
[11] 1964 2 QB (CA) 499.
[12] par 130 – 139.
[13] par 137.
[14] par 139.

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properly considers the South African common law.[15] By contrast, the concurring judgment shows a long line of decisions of the courts that have consistently held that ostensible authority is a form of estoppel.[16] Most of these judgments are explicit in this recognition. Moreover, *NBS Bank Ltd* has been followed by several supreme court of appeal decisions afterwards, all following the principle expressed there.[17] The blanket denial of the content of the case law before *NBS Bank Ltd* and of the cases that followed it does not convince.[18] The application of estoppel in other areas of contract law, such as where there is a lack of consensus, is not relevant to the enquiry at hand.[19]

Despite all of this, the main judgment holds that the only requirement to find ostensible authority is that

> "*it is shown that a principal by words or conduct has created an appearance that the agent has the power to act on its behalf*. Nothing more is required. The means by which that appearance is represented need not be directed at any person. In other words the principal need not make the representation to the person claiming that the agent had apparent authority. The statement [referring to the passage from *Hely-Hutchinson* relied upon] indicates the absence of the elements of estoppel. It does not mention prejudice at all (emphasis added)"[20]

It then proceeds to test the facts against this narrow test and finds that Geissler did have ostensible authority to act on behalf of Vodacom. The need to plead in replication falls away, because estoppel is not in play.

The concurring judgment comes to the same ultimate conclusion, but on more solid grounds. In keeping with the settled position voiced by the supreme court of appeal on more than one occasion, it held that ostensible authority is a form of estoppel.[21] The concurring judgment has no trouble in applying the elements of estoppel to the facts at hand and coming to the conclusion that it had been proven.[22] The reason why Vodacom's argument had to fail is because it was not

[15] The main judgment limited its consideration of the post-constitutional state of law to the interpretation of the Prescription Act 68 of 1969, which falls outside of this discussion. The part of its judgment dealing with the nature of ostensible authority did not rely on any constitutional interpretation or development of the common law. See the concurring judgment's criticism of the manner in which a reliance on development of the common law was approached by the appellant in this case (par 159 – 161).

[16] *Van Blommenstein v Holiday* (1904) 21 SC 11 17; *In re Reynolds Vehicle and Harness Factory Limited* (1906) 23 SC 703 712; *Strachan v Blackbeard and Son* 1910 AD 282 287 290 295 – 296; *Monzali v Smith* 1929 AD 382 385; *West v Pollak and Freemantle* 1937 TPD 64 68; *Insurance Trust & Investments v Mudaliar* 1943 NPD 45 58; *Clifford Harris (Rhodesia) Ltd v Todd NO* 1955 3 SA 302 (SR) 303F – H; *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 2 SA 11 (T) 14C – E 18H – 19E; *Inter-Continental Finance & Leasing Corp (Pty) Ltd v Stands 56 and 57 Industria Ltd* 1979 3 SA 740 (W) 748B – C; *Connock's (SA) Motor Co Ltd v Sentraal Westelike Ko-operatiewe Maatskappy Bpk* 1964 2 SA 47 (T) 49A – 53B; *Service Motor Supplies (1956) (Pty) Ltd v Hyper Investments (Pty) Ltd* 1961 4 SA 842 (A); *Southern Life Association Ltd v Beyleveld NO* 1989 1 SA 496 (A); *African Life Assurance Co Ltd v NBS Bank Ltd* 2001 1 SA 432 (W) 451E – H; *Glofinco v ABSA Bank Ltd (t/a United Bank)* 2001 2 SA 1048 (W) 1064A – B.

[17] *South African Eagle Insurance Co Ltd v NBS Bank Ltd* 2002 1 SA 560 (SCA); *Glofinco v ABSA Bank Ltd t/a United Bank* 2002 6 SA 470 (SCA); *South African Broadcasting Corporation* (n 8); *MEC for Economic Affairs, Environment and Tourism v Kruizenga* 2010 4 SA 122 (SCA); *Northern Metropolitan Local Council v Company Unique Finance (Pty) Ltd* 2012 5 SA 323 (SCA).

[18] par 70 – 71.

[19] par 72 – 74.

[20] par 47.

[21] par 109, 140 and 154.

[22] par 155 – 156, 164 – 184.

necessary to plead ostensible authority in replication. The concurring judgment held that this rule was not part of South African law.[23]

Space does not allow me to go into a detailed exposition of the separation of powers and of the role of the courts.[24] Suffice it to say that not even the constitutional court has the power to create law out of thin air as the main judgment has apparently done in this case. It does not place the law of agency on any sounder footing than before. On the contrary, holding that ostensible authority is *actual* authority confuses me and I want to predict that it will confuse most of us.

It is one thing to say that a company must be kept bound to the acts of a purported agent because the company created an atmosphere of regularity about the extent of the powers of a particular individual that the company must have reasonably foreseen would be relied upon by others, potentially to their detriment. It is completely different to say that when a company created an atmosphere of regularity about the extent of an individual's powers, that the person actually had those powers. I submit that it extends the potential liability of companies to such an extent that many of the *fraudulent* acts of their employees may now be placed before their doors. This is because the individual could now be held to have acted as the company's agent.

To the long list of decisions that have held ostensible authority to be a form of estoppel must be added *One Stop Financial Services (Pty) Ltd v Neffensaan Ontwikkelings (Pty) Ltd.*[25] Here too the court held, in accordance with the long line of judgments mentioned above, that

> "… the Turquand rule is simply an adjunct, in the context of companies and other entities with constitutions available to the public, of the law of ostensible authority, which is in turn a particular form of estoppel by representation."[26]

This interpretation of the Turquand rule is, however, controversial. The judgment considered the validity of three contracts entered into by Neffensaan ("the company") with One Stop Financial Services (Pty) Ltd ("the lender"). The first was a suretyship agreement in favour of a company unrelated to Neffensaan, which was entered into before commencement of the Companies Act 71 of 2008 ("the act") on 1 May 2011. The other two were loans advanced to Neffensaan and were entered into after the act's commencement. The company had three directors – Moller, Coetzee and Bock. Moller represented the company's largest shareholder (Kruismansbaai) and Bock the other major shareholder (CLR). In lieu of the sale of immovable property by CLR to the company, it was agreed that a shareholders' agreement entered into between the parties would be incorporated into the memorandum of incorporation (MOI) of the company. However, it was entirely unclear whether this ever happened and evidence of the content of the company's MOI was not placed before the court.

[23] par 120 – 123.

[24] See Seedorf and Sibanda "Separation of powers" in Woolman and Bishop (eds) *Constitutional Law of South Africa* (2 ed) par 12.2(c). On the development of the common law, see s 39(2) of the Constitution of the Republic of South Africa, 1996; *Carmichele v Minister of Safety and Security* 2001 4 SA 938 (CC) par 55; Woolman "Application" in Woolman and Bishop (eds) supra 31-78 – 31-87 and 31-93 – 31-100; Davis "Interpretation of the Bill of Rights" in Cheadle, Davis and Haysom *South African Constitutional Law: The Bill of Rights* (Service Issue 20) par 33.3.

[25] 2015 4 SA 623 (WCC). This part of the discussion relies extensively on Locke "Neffensaan reg of verkeerd? Estoppel en die Turquand Reël" in Schlemmer and O'Brien (eds) *Gedenkbundel vir JC Sonnekus* (publication imminent).

[26] par 25.

The failure to put the MOI before the court should have been fatal to any reliance placed on the Turquand rule or on section 20(7) of the act. The Turquand rule only ever played a role to ameliorate the effects of the doctrine of constructive notice on third parties. A private shareholders' agreement has never enjoyed any constructive notice. Furthermore, section 20(7) is expressly only applicable to formal and procedural requirements of the act, the company's MOI or the company rules. However, the court did consider the arguments in favour of the application of the Turquand rule, possibly because the case considered an application for provisional liquidation. A bona fide dispute on reasonable grounds about whether the applicant was a creditor of the company would therefore be fatal to the application.[27]

As the quoted phrase above shows, the court interpreted the Turquand rule as an adjunct to the law of ostensible authority and continued to apply the elements of estoppel to the facts at hand. It held that since the lender on own admission did not carry any knowledge of the content of the company's articles of association, it could not claim to have relied on it in its actions.[28] The court applies estoppel incorrectly in this interpretation. All that is required to establish ostensible authority is that the purported agent acted within the scope of his or her *usual* authority. Usual authority is the powers that are usually conferred on an individual that holds a particular office in a company. It may encapsulate both actual implied authority and ostensible authority. It appears that most of the business of the company was transacted directly by its directors, which means that their usual authority would be very broad. If anything, the fact that the suretyship was extended to an unrelated company could have made it suspicious, which would have barred a reliance on estoppel. This would still not affect the loan agreements, which were entered into for the benefit of the company.

The court held that section 20(7) of the act must be interpreted consistently with the well-established interpretation of the Turquand rule, which held that a third party could not rely on a general delegation of authority contained in an MOI to hold that a specific person was given authority in a particular instance.[29] Given that section 20(7) could not apply to the facts in this case, these comments must be seen as obiter. However, I submit that they are correct. I have also argued elsewhere in support of the court's interpretation of the role of the Turquand rule as an adjunct to ostensible authority.[30] This is admittedly not the widely-held opinion, but it is in my view the correct one. It remains to be seen what the future worth of the *Neffensaan* decision will be in view of the constitutional court's judgment in *Makate*.

## 3 *Remedies*

The supreme court of appeal has recently had the opportunity to consider the constitutionality of orders of delinquency as provided for in section 162 of the act. In *Gihwala v Grancy (Pty) Ltd*[31] the directors were found to have acted in breach of their duties towards their company and to have illegally benefitted from

[27] par 5 and 6 with reference to *Kalil v Decotex (Pty) Ltd* 1988 1 SA 923 (A) 975J – 979F and *Badenhorst v Northern Construction Enterprises (Pty) Ltd* 1956 2 SA 346 (T) 347H – 348C.

[28] par 44.

[29] *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 2 SA 257 (W) 262E – 264D; *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief* 1978 2 SA 11 (T) 15E – H.

[30] Locke (n 25).

[31] (20760/2014) [2016] ZASCA 35 (24 March 2016).

their positions as director.[32] It was therefore clear to the court that an order for delinquency was justified. However, the appellants argued that section 162(5) of the act was unconstitutional. The first leg of this argument was that it operated retrospectively, since an order for delinquency could be made for actions that occurred before commencement of the legislation.[33] However, this argument fell away on the basis of the principle that a statute is not retrospective simply because some of an action's requisites date from a time before its passing.[34] The argument therefore mainly rested on the second contention, namely that the lack of discretion afforded to the court in section 162(5) in ordering delinquency offended against the constitutional rights to dignity, the right to choose a trade, occupation or profession and the right to access to courts.[35]

The court held that the purpose of section 162 is not penal, as was argued by the appellants. Rather the purpose is to protect the investment public against directors who are patently incapable of acting responsibly in their roles as directors.[36] The types of behaviour that could lead to an order for delinquency all involve serious misconduct. It is irrelevant whether the company suffered direct loss as a result of the actions of the directors, because the order for delinquency aims to protect the public. Section 162(5) therefore is entirely rational.[37]

The constitutional court has held that the regulation of vocational activity for the protection of both participants and the larger public must be welcomed, as long as it is not capricious or arbitrary.[38] Section 162(5) being not arbitrary nor capricious, the attack on its validity on the ground that it infringes on the right to choose a trade, occupation or profession therefore had to fail.[39] Since the court is involved in every aspect of the delinquency order, it cannot be contended that it infringes on the right to have access to the courts.[40] The challenge based on the right to dignity was similarly dismissed. The delinquency order is not a sentence for criminal conduct or a sanction for misconduct. The order follows from serious misconduct and aims to protect the public.[41]

In the same matter the supreme court of appeal reaffirmed when a personal action based on breach of fiduciary duty would be available. This was in answer to an argument, based on the rule in *Foss v Harbottle*,[42] that the claims against the appellants must have been brought by the company rather than by the respondent as a shareholder. Two instances are identified. The first is when a wrong is committed against the shareholder, but not against the company.[43] In such an instance an action will be available to the shareholder, even if the measure of her loss is the diminution of the value of her shareholding. The second is if a separate fiduciary

32 For a full list of these breaches and illegalities, refer to par 138.
33 par 140.
34 par 141 on authority of *Krok v Commissioner, South African Revenue Service* 2015 6 SA 317 (SCA) par 40.
35 par 141.
36 par 142.
37 par 145.
38 *Affordable Medicines Trust v Minister of Health* 2006 3 SA 247 (CC) par 57 – 60.
39 par 146.
40 par 147.
41 par 148 – 150.
42 (1843) 2 Hare 461 (67 ER 189). See further *Prudential Insurance Co Ltd v Newman Industries Ltd (No 2)* 1982 1 All ER 354 (CA) and *Johnson v Gore Wood & Co (a firm)* 2001 1 All ER 481 (HL).
43 par 109 – 110.

duty is owed to the shareholder apart from the duty owed to the company.[44] Then the company and the shareholder may each sue to recover loss caused to it, but may not sue to recover loss suffered by the other party. In the present matter the claims of the respondents were based on a separate fiduciary relationship that existed between them and the appellants resulting from the investment agreement entered into between them. Their loss therefore did not belong to the company and fell in the second of the instances described.

Most of the *Gihwala* case concerned the interpretation of the investment agreement between the parties. As an alternative, the respondents tried to advance a case for the application of section 424 liability of the appellants for the reckless or fraudulent conduct of the business of the company. The court rejected this on the basis that there was no evidence before it that the company was unable to pay its debts. The court felt itself bound to the decisions in *L & P Plant Hire BK v Bosch*,[45] *Saincic v Industro Clean (Pty) Ltd*[46] and *Fourie v Firstrand Bank Ltd*.[47]

The supreme court of appeal delivered another judgment mostly dealing with the issue of the proper plaintiff in company actions only two weeks after *Gihwala*. In *Itzikowitz v ABSA Bank Ltd*[48] the appellant was a sole shareholder in a company (Compass) which held a 17.29% shareholding in another company (QPG). QPG in turn held a sole shareholding in a property development company (AMU). ABSA was a major creditor of both QPG and AMU and was the applicant in AMU's successful liquidation application. The business failure of AMU caused the suretyship granted by the appellant in favour of the bank to become payable. The matter before the court considered a counterclaim to the claim of the bank in terms of the suretyship. The appellant alleged that the bank recklessly continued to lend money to AMU when there was no reasonable chance of the money being repaid and that these actions together with the liquidation of the company caused the appellant's indirect shareholding in AMU to be diminished to no value. The South Gauteng High Court dismissed this counterclaim on the basis that the bank had no legal duty to consider the interests of the appellant in conducting its affairs. The appeal was against this order.

The bank's argument against the counterclaim was simply that if any damages had been suffered at all, it was suffered by the company and not by a shareholder thrice removed.[49] Support for this position comes from the same authority as cited above in the discussion of *Gihwala*.[50]

In turn the appellant relied on three judgments that muddied the waters, all dealing with the principle of "double jeopardy". In *McLelland v Hulett*[51] it was held that the proper-plaintiff principle, while harking back to the separate legal personality of the company, really has as its objective to guard against holding the wrongdoer liable more than once for the same conduct. Following from this, the rule did not apply where the company could not institute action. In *Kalinko v Nisbet*[52] the court approved the approach in *McLelland* and held that where

[44] par 110, approving *Gore Wood* (n 42) 503F – G.
[45] 2002 2 SA 662 (SCA) par 40.
[46] 2009 1 SA 538 (SCA) par 27.
[47] 2013 1 SA 204 (SCA) par 28 – 30.
[48] 2016 4 SA 432 (SCA).
[49] par 9.
[50] See n 42 above.
[51] 1992 1 SA 456 ((D) 47B – H.
[52] 2002 5 SA 766 (W) 778D – 779C.

double jeopardy is not at issue a shareholder could sue for the diminished value of his shareholding. These two judgments were followed in *McCrae v ABSA Bank Ltd*,[53] where the court allowed a shareholder to sue for diminution of the value of his shareholding caused by the wrongful actions of the bank in relation to the companies in question.

The court rejected all three these cases on the basis that the true enquiry must be whether the defendant had independently wronged the plaintiff.[54] This is because the separate legal personality of the company is "a matter of substance".[55] The first step is to determine in which of the three categories, set out in *Johnson v Gore Wood & Co (a firm)*,[56] a claim against a defendant falls. The categories are as follows:

- If the company suffers a loss owing to a breach of a duty owed to it, a shareholder has no claim for diminution of shareholding where it merely reflects the loss caused to the company;
- If the company has suffered loss, but has no cause of action, the shareholder may sue if he or she has a cause of action. This is so even if it is on the basis of a diminution of value of his or her shareholding;
- Where a company suffers loss as a result of a breach of a duty owed to it and a shareholder suffers loss as a result of a breach of an independent duty owed to him or her, each may recover their own losses. However, they may not recover losses based on each other's cause of action. This was the situation of the respondent in the *Gihwala* decision discussed above.

The court held that double recovery could only be possible in the last of these instances:

> "The fact that double recovery may not be likely in a particular situation does not create an entitlement in the hands of a shareholder which he or she did not have in the first place. Where there is only one wrong, that was committed against the company, the risk of double recovery simply does not arise. The fact that the company has chosen not to sue, or is unable to sue, does not convert that wrong into a wrong against its shareholders. The risk of double recovery only becomes relevant when both the company and its shareholder(s) have been independently wronged (the third category in *Johnson v Gore*)."[57]

In the *Itzikowitz* matter the wrongs committed, if proven, would be against the company and the losses would be those of the company.[58] The appeal was accordingly dismissed. It is interesting to note that a second counterclaim of the appellant was allowed to proceed to trial. This counterclaim is based on section 218(2) read with section 22(1) of the act.[59] At the time of writing, this matter has not yet appeared before court. Watch this space next year …

On a completely different front, the South Gauteng High Court certified the class action of employees of the gold mining industry, who contracted silicosis or

[53] (08/42229) 2009 ZAGPJHC 7 (7 April 2009).
[54] par 16.
[55] with reference to *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530 at 550.
[56] See n 42.
[57] par 17.
[58] par 12 and 20.
[59] Section 218(2) provides that any person who contravenes any provision of the act is liable to any other person for any loss or damage suffered by that person as a result of that contravention. Section 22(1) provides that a company must not carry on its business in a reckless, grossly negligent or fraudulent manner.

tuberculosis as a result of their working environment in the mines.[60] The defendant group will consist of most of the mining houses in South Africa and includes their holding companies. This matter will take up the time and efforts of most of the best known advocates in the country for some time to come. The order included that any settlement reached must first be approved by the court.

4 *Access to securities registers*

In *Nova Property Group Holdings Ltd v Cobbett*[61] the supreme court of appeal held that section 26(2) of the act provides an unqualified right of access to any person who requests access to the securities registers of the company. This right is not subject to the exceptions listed in the Promotion of Access to Information Act 2 of 2000 ("PAIA"), nor does the requester need to show that he or she needs the access for the protection of his or her rights, which is the essential requirement to gain access to information held by a private body in terms of PAIA. It is also not subject to any reasonableness requirement.[62] The motive of the requester is irrelevant in this regard.

Section 26(7) clearly states that the rights of access to information granted in terms of the section are in addition to those granted in terms of PAIA and not in substitution of those rights. A contrary *obiter dictum* in *La Lucia Sands Share Block Ltd v Barkhan*[63] was overruled.[64] The uncertainty probably slipped in with the interpretation of section 26(4), which provides that

> "A person may exercise the rights set out in subsection (1) or (2), or contemplated in subsection (3) –
>
> (a) for a reasonable period during business hours;
>
> (b) by direct request made to the company in the prescribed manner, … *or*
>
> (c) in accordance with the Promotion of Access to Information Act, 2000 (emphasis added)"

Elsewhere in the act there are instances where the courts have interpreted the words "or" to mean "and", and the other way round.[65] However, the legislative history pointed towards the intentional inclusion of the "or" in this instance.[66] This means that, procedurally, a requester may either seek direct access for a reasonable period during business hours, or follow the procedure set in PAIA.[67]

The court further opined that unrestricted access is in the public interest, as it would benefit the work of investigative journalism and further the objective of the act to encourage transparency and high standards of corporate governance.[68] The possible infringement on the rights of privacy of shareholders of a company is so limited that it could not bar access as granted by the act. In any event, the constitutionality of section 26(2) was not disputed by the appellants.[69]

[60] *Nkala v Harmony Gold Mining Company Ltd* 2016 5 SA 240 (GJ).
[61] 2016 4 SA 317 (SCA).
[62] par 26 – 28.
[63] 2010 6 SA 421 (SCA).
[64] par 25.
[65] See, for instance, the discussion in par 6.3 below.
[66] par 30 – 32.
[67] par 20.
[68] par 18 with reference to s 7(*b*)(iii). The court allowed submissions by the Mail & Guardian Centre for Investigative Journalism as an *amicus curiae*. See also par 37 – 38.
[69] par 40 – 42.

It is submitted that the court's interpretation of the relevant provisions in section 26 and its interaction with PAIA is correct. However, this is probably a pyric victory for access to information about interests in securities. Firstly, the use of nominees in the securities registers of companies is ubiquitous. While such nominees must disclose the beneficial holder in the case of public companies,[70] nominees on the securities registers of state-owned and private companies need only make such disclosure if they would be a regulated company for purposes of the Takeover Regulations.[71] Even then, the disclosure does not need to state any related persons to the beneficial holder of the securities, which means that the ultimate benefactor of holdings may remain undisclosed. Requesters will still have to resort to a PAIA procedure to gain access to this information. It is very clear from the judgment that there is a real sense of frustration with the practicality of the PAIA procedure and this must receive legislative attention.[72]

## 5 *Security for costs*

Several previous judgments have considered whether courts retain the discretion to order *incola* companies to furnish security for costs now that an express provision granting such discretion no longer appears in the act.[73] The supreme court of appeal has now had the opportunity to weigh in and to bring some finality to this matter.

In *Boost Sports Africa (Pty) Ltd v South African Breweries (Pty) Ltd*,[74] a judgment that must be applauded for its sobriety, the court held that the superior courts could compel a company to furnish security for costs at common law – a discretion which results from the inherent power of the courts to regulate their own proceedings. In absence of a provision similar to section 13 of the act, plaintiff individuals and companies will now be similarly assessed to determine whether they should furnish security for costs. This implies that the discretion of the court will only be exercised if the court is satisfied that the main action or application is vexatious, reckless or otherwise amounts to an abuse.[75] This is the case even where there is otherwise a slim chance that the plaintiff company would be able to meet an adverse costs order.

In deciding whether an action or application is vexatious, the court referred to well-known dicta in *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*[76] and *African Farms and Townships Ltd v Cape Town Municipality*.[77] A detailed investigation into the merits of the plaintiff's case is not necessary. The extent of the investigation should rather be determined by the nature of the dispute.[78]

[70] s 56(3) and (4) read with reg 32(3).

[71] s 56(7)(*a*) read with s 117(1) and s 118(1) and (2).

[72] par 23 – 24.

[73] *Haitas v Port Wild Props 12 (Pty) Ltd* 2011 5 SA 562; *Siemens Telecommunications (Pty) Ltd v Datagenics (Pty) Ltd* 2013 1 SA 65 (GNP); *Hennie Lambrechts Architects v Bombenero Investments (Pty) Ltd* 2013 2 SA 477 (FB) and *Maigret (Pty) Ltd (in Liquidation) v Command Holdings Ltd* 2013 2 SA 481 (WCC).

[74] 2015 5 SA 38 (SCA). See *Boost Sport Africa (Pty) Ltd v South African Breweries Ltd* 2014 4 SA 343 (GP) for the judgment of the court a quo.

[75] par 16.

[76] 1979 3 SA 1331 (W) 1339E – F.

[77] 1963 2 SA 555 (A) 565D – E. See par 17 of *Boost Sports Africa* (SCA) (n 74).

[78] par 19 on authority of *Zietsman v Electronic Media Network Ltd* 2008 4 SA 1 (SCA) par 21.

Section 13 of the Companies Act 61 of 1973 guarded against the situation where an action by a company is funded by those who stand to benefit from the action's success, usually shareholders, but where the company does not have the funds to pay for a costs order against it made in favour of the defendant.[79] The court held that this mischief remains and that it had reason to believe that it was present in the case before it.[80] It therefore declined to interfere with the discretion of the high court to order that security for costs be furnished by the plaintiff.

## 6 *Business rescue*

Following the trend of recent years, most of the decided cases concerned business rescue proceedings. There continues to be much uncertainty about many aspects of the procedure in chapter 6 of the act, which inevitably – and sometimes conveniently – leads to litigation.

### 6.1 The setting aside of proceedings

In *ABSA Bank Ltd v Golden Dividend 39 (Pty) Ltd*[81] the bank applied to have the business rescue proceedings set aside and instead to have the company placed in liquidation. The basis of the application was that there was no reasonable prospect of rescuing the company,[82] or alternatively, that after consideration of all the evidence it was otherwise just and equitable to do so.[83] The court dealt with this substantive part of the application last, but it formed the basis of the court's decision in the matter. All the preceding aspects of the court's judgment may therefore be considered obiter. I deal with these aspects briefly before returning to the main grounds.

The court made short shrift of an argument by the respondents that all the creditors of the company had to be joined to the application as interested parties. Section 130 read with section 145(1) only provides that notice must be given to creditors of an application to set aside the proceedings.[84] The need for a joinder is not implied from the mentioned provisions, nor is joinder reconcilable with the temporary nature of the business rescue proceedings. Note that the joinder of creditors is necessary at a later stage when there is an application for the setting aside of an approved business rescue plan.[85]

A second argument raised by the bank was that the extension of the time-limit for the publication of the business rescue plan could only be granted at a validly convened creditors' meeting.[86] In casu the majority creditor of the company granted permission for the extension of the time-limit, but the meeting where such permission was granted had not been validly convened. The wording of section 150(5)(*b*) provides that the holders of the majority of the creditors' voting interests may grant an extension of time for the publication of the business rescue plan. The court held that, unlike other sections in chapter 6 of the act where the convening of a creditors' meeting is specifically mentioned,[87] this section makes no mention of the

[79] *MTN Service Provider (Pty) Ltd v Afro Call (Pty) Ltd* 2007 6 SA 620 (SCA) par 20.
[80] par 26.
[81] 2015 5 SA 272 (GP).
[82] s 130(1)(*a*)(ii).
[83] s 130(5)(*a*)(ii).
[84] par 27 – 29.
[85] Refer to par 6.5 below.
[86] par 32 – 42.
[87] See for instance s 143(2) and (3), considered later in the *Golden Dividend* judgment (par 66 – 69), where a meeting must be convened to approve further remuneration for the business rescue practitioner.

need to convene a creditors' meeting to gain the required permission. Contrary to *DH Brothers Industries (Pty) Ltd v Gribnitz NO*,[88] the court held that the required permission may be granted outside of a validly convened creditors' meeting.

In this particular matter it was not disputed that the creditor who granted the permission to extend the time-limit was the majority creditor of the company. While one cannot fault the reasoning of the court in coming to the conclusion that a formal meeting is not required by the wording of the act, one wonders whether this approach would still be acceptable in cases where the claims against the company were in dispute. Unnecessary litigation only works against the temporary nature of the procedure. On the other hand, convening unnecessary meetings when there is clearly a majority creditor who may consent to an extension is costly and may also waste time. In the end, I prefer the approach in *Golden Dividend*. It leaves some discretion in the hand of the practitioner to decide whether a formal meeting is necessary in the circumstances.

The court held that the business rescue plan that was considered and approved did not comply with the substantive requirements for a business rescue plan as set out in section 150. It simply did not contain all the relevant information, reasonably required, to facilitate a decision whether or not to accept the proposed plan.[89] However, the court held that the plan was procedurally correctly adopted.[90]

The court left open the question whether a failure to comply with the substantive content requirements set in the act could lead to the invalidly of the adoption of the plan.[91] Chapter 6 does not provide for a remedy in this situation. Section 150(1) is put in peremptory terms, but there is no procedure in the act to dispute the validity of an adopted business rescue plan.

Perhaps the idea was that a majority vote would imply a condonation by the majority of the holders of creditors' voting interests of the content of the plan, however sketchy it might be. However, such an approach goes against the very definition of business rescue, namely that the plan must maximise the likelihood of the company's continuing existence on a solvent basis, or otherwise raising a higher return for creditors than would otherwise result from immediate liquidation. If a business rescue plan becomes so vague that one cannot ascertain whether there is any likelihood of these objective being met, there is a real danger of abuse of the process to the detriment of some creditors.

The potential detriment of preferent creditors in liquidation must be mentioned here.[92] The voting interests in business rescue is set up in such a manner that preferent creditors in insolvent liquidation and pre-commencement concurrent creditors have equal voting rights.[93] This state of affairs may be defendable while there is a realistic prospect of meeting the objectives of business rescue. However, it cannot remain defendable when the meeting of the objectives cannot be ascertained from the proposed business rescue plan. Creditors vote in self-interest and so they should. The procedures must therefore be robust enough to provide transparency and the necessary protections.

[88] 2014 1 SA 103 (KZN) par 29 – 32.
[89] par 43 – 46.
[90] par 52.
[91] par 53 – 55.
[92] See in this regard *Commissioner, South African Revenue Service v Beginsel NO* 2013 1 SA 307 (WCC) par 25 – 35 and the discussion of this case in Locke and Esser "Company law and stock exchanges" 2013 *Annual Survey of South African Law* 271 – 275.
[93] See s 145(4)(*a*).

As it stands an affected person must apply for the setting aside of a resolution to initiate business rescue before the business rescue plan is adopted.[94] A meeting to consider the adoption of the business plan must be convened *within* ten business days after the publication of the business rescue plan,[95] and five business days' notice is required for the meeting.[96] The turnaround time between publication of a business rescue plan and the meeting to consider the plan may therefore be as short as five business days. Supposing the idea is that all substantive failures of the minimum content of a proposed business rescue plan must be disposed of via section 130(1), this leaves very little time for a creditor to act. It further means more costly litigation. Moreover, it forces a possibly inappropriate application for the setting aside of the procedure, when it might still be possible to amend the business rescue plan in order to show a reasonable prospect of rescue. It would be much more appropriate to include a provision in the act to the effect that substantive non-compliance with the minimum content requirements set in section 150 would lead to the invalidity of the adoption of the business rescue plan if so ordered by a court on application by an affected person and within a prescribed time. As mentioned in *Golden Dividend*,[97] such a remedy would not amount to a review mechanism by disgruntled creditors, but would rather reinforce the peremptory requirements set in the act.

However, in *Golden Dividend* the adopted business rescue plan was before the court. The application for the setting aside of the resolution that initiated the business rescue proceedings was launched in time,[98] that is before the adoption of the business rescue plan, but subsequently the plan was voted on and adopted in a procedurally correct manner. In effect the court was reviewing the plan to come to the conclusion that there was no reasonable prospect of rescue.[99] I am not convinced that the aim of section 130(1) is to provide an indirect avenue for judicial review of the content of a business rescue plan. At the same time, it is unwise to rewind the clock and expect that a judgment must be made of known facts at the time of the resolution when it has already crystallised what the business rescue plan would look like. I suspect that this situation was not contemplated by the legislature. It could be remedied by requiring a section 130(1) application to be finalised before there may be a vote on a business rescue plan.

### 6.2 The moratorium

*Chetty t/a Nationwide Electrical v Hart NNO*[100] considered whether arbitration proceedings fall within the meaning of "legal proceedings" as used in section 133 of the act.[101] A dispute between the parties was referred to arbitration and the

[94] s 130(1)(*a*). That was the case in *Golden Dividend*, making the question of the lack of substantive compliance with the minimum content of the business rescue plan superfluous.

[95] s 151(1).

[96] s 151(2).

[97] par 55.

[98] See s 130(1).

[99] par 61 – 65.

[100] 2015 6 SA 424 (SCA).

[101] "During business rescue proceedings, no legal proceeding, including enforcement action, against the company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced or proceeded with in any forum, except (*a*) with the written consent of the practitioner (*b*) with the leave of the court and in accordance with any terms the court considers equitable …"

award was made while the company was the subject of business rescue proceedings. The dispute concerned a claim by the appellant as well as a counterclaim by the company. The arbitral award held the counterclaim to amount to about ten times more than the claim of the appellant, with which she was not satisfied. The appellant therefore tried to have the arbitration declared invalid on the basis that the business rescue practitioner's consent was not obtained to proceed with the arbitration as a form of legal proceeding in terms of section 133(1).

The court a quo held that arbitration did not fall within the meaning of "legal proceeding",[102] but this finding was overturned on appeal. The supreme court of appeal held that both the ordinary meaning of the phrase in a wider sense and the contextual reading of the phrase lead to a conclusion that arbitration ought to fall within the meaning of "legal proceeding" in section 133(1).[103] The duty of the current management of the company to supply the business rescue practitioner with details of any court, arbitration or administrative proceedings as set out in section 142((3)(*b*) supports such a finding – the latter particularises the proceedings that are affected by section 133(1). The court makes the very valid observation that arbitration is resorted to regularly in commercial dealings and that the usefulness of the moratorium would be severely hampered if arbitration were to be excluded from the ambit of section 133(1).[104]

However, the absence of consent by the business rescue practitioner to proceed with the arbitration proceedings does not lead to the invalidity of the proceedings. The moratorium on legal proceedings is provided for as an instrument for the financially distressed company to rearrange its affairs.[105] It cannot come to the aid of third parties, such as the appellant.[106] She therefore did not have standing to use section 133(1) to declare the arbitration invalid. Furthermore, there is no indication in the legislation that proceedings in absence of consent would be a nullity.[107]

*Cloete Murray NNO v Firstrand Bank Ltd t/a Wesbank*[108] considered whether the cancellation of an instalment sale agreement after the initiation of business rescue proceedings was contrary to the moratorium in section 133(1). The respondent bank sold goods to the company in terms of an instalment sale agreement. Shortly after the initiation of business rescue proceedings, the bank cancelled the agreement. The business rescue practitioner consented to the repossession and sale of the goods in satisfaction of the bank's claims.[109] The sale realised an excess of R800 000 above the value of the claim by the bank against the company, which the bank used to set-off other amounts owing to it. The business rescue ended in liquidation. The matter before the court was brought by the liquidators of the company, who argued that the cancellation was contrary to the moratorium in the sense that it constituted enforcement action. They asked that the full realised value be returned to the insolvent estate to be dealt with in accordance with section 83 and 84 of the Insolvency Act 24 of 1936.

The court held that the cancellation of a contract does not amount to "enforcement action". Section 133(1) refers to "legal proceeding, including enforcement action",

[102] *Chetty v Hart NO* 2014 JDR 0585 (KZD).
[103] par 12 – 29, 35.
[104] par 28.
[105] par 39.
[106] par 43.
[107] par 41 – 42.
[108] 2015 3 SA 438 (SCA).
[109] par 6.

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which suggest that the enforcement action must be such that it resulted from legal proceedings in any forum.[110] Cancellation is a unilateral act by a party to contract and does not require any legal proceeding to occur.[111]

The court made certain obiter comments regarding the cancellation of agreements during business rescue. First, the business rescue practitioner is given the power to suspend any contract during the period of business rescue and to apply to court for the cancellation of a contract. This power would be superfluous if rights and obligations were suspended automatically owing to the moratorium.[112] Secondly, if cancellation of obligations is allowed, amounts owing to the creditor must be dealt with in business rescue and will only be enforceable after implementation of the business rescue plan as outlined in the plan.[113]

The judgment in *Cloete Murray NNO* makes it seem as if the legal position relating to executory contracts in business rescue is clear-cut. This is deceiving. In *Cloete Murray NNO* the event of default that led to the activation of the cancellation clause occurred before the initiation of business rescue. Furthermore, it seems as if the business rescue practitioner did not elect to suspend the contract, but in fact cooperated with the bank in the repossession of the goods after cancellation. Van der Linde argues that any suspension by die practitioner of a contract would immediately suspend rights to cancellation and acceleration on default, because default could only again occur after termination of the business rescue.[114] It seems to me that this is a sound argument. *Cloete Murray NNO* also does not make it clear whether cancellation or acceleration triggered by the initiation of business rescue is allowed, or whether this could be construed as an illegal agreement, since it removes the ability of the practitioner to elect to suspend the contract. I have always been in favour of allowing the cancellation or acceleration as triggered by business rescue – it remains open to the business rescue practitioner to negotiate with the relevant creditors in his or her compilation of the business rescue plan to reach an agreement that will benefit all involved.

I am a little baffled as to why the liquidators sought to have the cancellation of the instalment sale agreements set aside on the basis of section 133(1) of the act, when they could have voided the cancellation by means of section 84(2) of the Insolvency Act. The reported judgment states that the goods were repossessed by the bank in the first week of July 2012 and the provisional liquidation order was given on 17 July 2012. The date of commencement of the insolvency is therefore deemed to have been on the date of the presentation to court of the application for winding-up, which must have been before 17 July 2012.[115] Section 84(2) provides that

> "If the debtor returned the property to the creditor within a period of one month prior to the sequestration of the debtor's estate, the trustee may demand that the creditor deliver to him that property or the value thereof at the date when it was so returned to the creditor, subject to payment to the creditor by the trustee or to deduction from the value (as the case may be) of the

[110] par 32.
[111] par 33.
[112] par 35 and 39.
[113] par 35.
[114] Van der Linde "National report for South Africa" in Faber, Vermunt, Kilborn and Van der Linde *Treatment of Contracts in Insolvency* (2013) 375. See further *Kythera Court v Le Rendez-vous Café CC* (2016/11853) [2016] ZAGPJHC 172 (22 June 2016) par 15.
[115] s 348 of the Companies Act 61 of 1973. See further Blackman, Jooste, Everingham, Yeats, Cassim, De la Harpe, Larkin and Rademeyer *Commentary on the Companies Act* (Revision Service 9, 2012) 192 et seq.

> difference between the total amount payable under the said transaction and the total amount actually paid thereunder. If the property is delivered to the trustee the provisions of subsection (1) shall apply."

It seems to me as if the goods were returned to the bank within a period of one month before the winding-up application was presented to court, but perhaps some details of the facts were not conveyed in the reported judgment.

Another judgment that considered the effects of a cancellation of a contract was *LA Sport 4x4 Outdoor CC v Broadsword Trading 20 (Pty) Ltd*.[116] In this case the appellants sold a business in terms of a franchise agreement to the company. The franchise agreement provided for the cancellation of the agreement if the amounts owing to the appellants fell into arrears. The cancellation would trigger an undertaking to retransfer the business to the appellants and the company would lose all licenses to trade with the appellants' brand. The contract was cancelled after the business rescue proceedings were voluntarily initiated.

It is clear from the judgment that the pleadings were very shoddily drafted. It tried to make out a case that the court's consent must first be obtained before an affected person may apply to have business rescue proceedings set aside, when this right is clearly conferred on affected persons in section 130(1). Two of the sections of the act relied upon by the company, namely section 133(3) and section 134(1)(*c*), were not relevant at all. This included an argument that letters of demand and notices of cancellation constituted legal process for purposes of section 133(1). The court made short shrift of this – cancellation is a juristic act, not a legal process.[117] Moreover, it does not depend on proceedings in any forum, as is clearly envisaged in section 133(1).

The long and the short of this judgment is that the court allowed the cancellation of the agreement after business rescue was initiated. The effect of the cancellation was that any further dealing with the brand of the appellants was in fact unlawful and that the whole substratum of the business of the company thereby fell away. This is not contrary to the objectives of business rescue. The objective is to save the business, not the company. In this scenario the business would be transferred back to the appellants who previously operated it very successfully. The business is in other words saved by the terms of the franchise agreement.

In *Southern Value Consortium v Tresso Trading 102 (Pty) Ltd*[118] the owner of immovable property wanted to use its *rei vindicatio* for the return of leased property after the lease agreement was cancelled before commencement of business rescue. The business rescue practitioner argued that such an order would be contrary to section 133(1) and 134(1)(*c*) of the act. Both of these provisions refer to the lawful possession of the company of property belonging to another. The court held that in this case the cancellation of the lease agreement implied that the company no longer held lawful possession of the immovable property.[119] The moratorium therefore did not apply to the situation at hand. A similar finding was reached by the court in *Kythera Court v Le Rendez-vous Café CC,* which presented with similar facts.[120] In this matter the lease was cancelled after commencement of business rescue. The court held that the cancellation was valid and that the *rei vindicatio* could be used

[116] 2015 JDR 0405 (GP).
[117] par 43.
[118] (16139/2015) 2015 ZAWCHC 174 (23 November 2015).
[119] par 30 – 33.
[120] (n 114).

against the unlawful occupier in this case. If the business rescue practitioner used his power to suspend the lease agreement, the right to cancel would also have been suspended.[121] However, the lease was not suspended in this case.

*Cawood NO v Swanepoel*[122] considered the meaning of "enforcement action" in section 133(1) of the act. Lebaka Construction (Pty) Ltd ("the company") was a contractor for the Sekhukhune District Municipality, which owed it a substantial amount of money. Numan Investments CC ("Numan") was a creditor of the company. The company was placed under business rescue on 7 July 2015. Before this date, Numan obtained judgment against the company for debts owed to it and a writ of execution was issued against the movable property of the company. On 27 May the sheriff executed the writ by attaching the payment certificates held by the municipality in favour of the company and drawing an inventory of the certificates. Numan's attorney informed the municipality on 30 June that payment was due and payable. However, payment was not made to Numan before the intervening business rescue proceedings of the company. On 9 July the business rescue practitioners of the company informed Numan's attorney that the proceedings had been initiated and that he was barred in terms of section 133 to continue with the execution process. At the same time, they informed the municipality of their appointment and requested that the payment of the debt be made to the company in business rescue, rather than in terms of the execution order. In August 2015 the municipality paid the amount owing into the sheriff's account, who transferred it to Numan's attorney.

The question before the court was whether the execution action had been finalised before the commencement of business rescue, or whether the payment by the municipality to Numan still formed part of that action.

The court held that execution is a process that only ends upon the sale of assets at auction, which is akin to the payment made by the municipality in the present matter.[123] Property that has been attached by the sheriff remains the property of the debtor and may be returned to the debtor on payment of the debt owed.[124] The court accordingly ordered that the money received by the attorney on behalf of Numan be transferred to the business rescue practitioners on behalf of the company.

The court was correct in holding that the sale in auction still forms part of the execution process. It is also correct that the debtor remains the owner of the property until the sale is finalised. However, this judgment did not consider that an attachment creates a judicial pledge over the attached property in favour of the creditor.[125] It is submitted that section 134(3) of the act is relevant in this situation. The property attached in terms of a writ of execution amounts to a

[121] par 15.

[122] 2015 JDR 2073 (GP).

[123] par 25 – 28 on authority of *Firstrand Bank Ltd v Nkata* 2015 4 SA 417 (SCA) par 31 and 33.

[124] relying on *Simpson v Klein NO* 1987 1 SA 405 (W) and *Liquidators Union and Rhodesia Wholesale Ltd v Brown & Co* 1922 AD 549.

[125] Refer in this regard to Badenhorst, Pienaar and Mostert *Silberberg and Schoeman's The Law of Property* (2006) 407 – 408; Sonnekus "Terughoudingsbevoegdhede en oënskynlike spanning met saaklike sekerheidsregte en pandingsregte" 2015 *TSAR* 1. See *South African Congo Oil Co (Pty) Ltd v Identiguard International (Pty) Ltd* 2012 5 SA 125 (SCA) par 20, for the following statement in the context of the attachment of debts: "An attachment in execution creates a pignus judiciale, the effect of which is that control of the property attached passes from the judgment debtor to the officer entrusted with the execution of the writ, the dominium of the debt remaining with the judgment debtor …"

security interest held by the creditor over the property of the company, which means that the company would not be able to deal with such attached property without the consent of the execution creditor, unless the disposal will be sufficient to fully discharge the debt owed to the creditor. In the latter case, the creditor must be promptly paid after disposal, or security must be furnished to that creditor's reasonable satisfaction.[126]

Business rescue does not create a *concursus creditorum* as in the case of insolvency.[127] While an execution creditor loses her right in insolvency to realise the value of the assets attached,[128] this does not apply in the business rescue scenario. It is untenable to allow a situation, such as that which arose in this matter, where the slow realisation of the attached assets alone bars the execution creditor from receiving value from the judgment given in her favour. It is a matter of public policy that execution creditors must receive that which has been ordered in their favour.

I therefore submit that the term "security interests" in section 134(3) of the act must be interpreted wider than the definition of "security" in the Insolvency Act 24 of 1936 to include the judicial pledge in favour of the execution creditor.

The last case to be considered under this heading is *Eravin Construction CC v Bekker NO*.[129] This matter truly presented a mess of epic proportions. Briefly stated, a company called Ditona Construction (Pty) Ltd ("Ditona") made a payment to Eravin Construction CC ("the CC") a day after it was deemed to have commenced winding-up. Two years later the CC commenced voluntary business rescue, which terminated by reason of substantial implementation of the business rescue plan seven months later. Ditona's liquidators only traced the recipient of the void transfer of property shortly before the termination of the business rescue proceedings. Their claim was never included in the business rescue plan and they were never included in any of the proceedings – they were clearly an unknown creditor to the CC.

The liquidators argued that the transfer was void ab initio in terms of section 341(2) of the Companies Act 61 of 1973. To this the CC replied that the debt became unenforceable in terms of section 154(2) of the act, which provides that if a business rescue plan has been approved and implemented a creditor is not entitled to enforce any debt owed by the company immediately before the commencement of business rescue, unless provided for in the business rescue plan.

In answer to the averment of the CC, the liquidators argued that the debt owed by the CC to the estate of Ditona only became due after commencement of the business rescue proceedings and that the implication of this was that it was not affected by the provisions of section 154(2). It was contended that the meaning of "debt" as it is used in the Prescription Act 68 of 1969 should be used, namely a debt that was due from an obligation.[130]

[126] Sonnekus (n 125) 18 – 20 argues that in the event of competing real security rights and judicial pledge over realised property outside of insolvency, the order of preference of s 96 and 99 – 103 of the Insolvency Act should determine the distribution of proceeds, judicial pledge falling in a similar position as a pledge over movable property but fixing at the time of attachment by the sheriff.

[127] See Van der Linde (n 114) 367.

[128] s 359(1)(*b*) of the Companies Act 61 of 1973; s 98 of the Insolvency Act 24 of 1936; Bertelsmann, Evans, Harris, Kelly-Louw, Loubser, Roestoff, Smith, Stander and Steyn *Mars The Law of Insolvency in South Africa* (2008) par 20.10 and 22.7.

[129] (20736/2014) 2016 ZASCA 30 (23 March 2016).

[130] par 16.

The supreme court of appeal rejected this argument. The context of the Prescription Act is that the act must assist in the determination of when prescription starts to run. This may only occur when the creditor knows "the identity of the debtor and of the facts from which the debt arises".[131] Section 341(2) of the Companies Act 61 of 1973 and section 154(2) of the act are different – they are concerned with debts that are owed.[132] Section 341(2) clearly states that a disposition made after commencement of winding-up is void. The resulting debt is owed immediately.[133]

The court held that section 154(2) is equally clear – a debt owed before the commencement of the business rescue cannot be enforced after the plan has been adopted and implemented.[134] The court rejected an argument that section 154(2) only applies to creditors who had received notice of the commencement of the proceedings.[135] While acknowledging that the effect of the provision may be draconian, in the sense that creditors who carry no notice of the proceedings may be bound to the implemented business rescue plan, the court held that it is a matter for the legislature to rectify.[136]

I submit that there is potentially a different reason why a creditor who is not involved in the business rescue process cannot be bound by the adopted and implemented business rescue plan. Section 154(2) must be read in conjunction with section 154(1) of the act, which provides that the business rescue plan may provide for the discharge of the whole or part of the debt owing to a creditor *who has acceded* to such a discharge. Section 150(2)(*a*)(ii) requires that a complete list of the pre-commencement creditors of the company must be included in the business rescue plan. Section 150(2)(*b*)(ii) of the act, dealing with the proposals that the business rescue plan must include at a minimum, lists the extent to which the company is to be released from the payment of its debts.

I have criticised the lack of clarity in these provisions before, especially when read in conjunction with section 152(4), which provides that

> "A business rescue plan that has been adopted is binding on the company, and on each of the creditors of the company …, whether or not such a person
>
> (a) Was present at the meeting;
>
> (b) Voted in favour of the adoption of the plan; or
>
> (c) In the case of creditors, had proven their claims against the company."

When read together, it is my submission that these provisions do not provide for the release of the company of the obligation to pay pre-commencement creditors not included in the proceedings. If this were the intention, the legislator ought to have been much clearer, as the provisions work to dispose of already established rights of the creditors. There is a presumption against an interpretation of statutes that would lead to a disposition of rights, unless it is plain from the wording of the statute.[137] It cannot be said that section 154 makes it clear that pre-commencement claims against the company would be discharged outside of an express agreement with the creditors concerned. This supports an interpretation that the effect of

[131] s 12(3) of the Prescription Act 68 of 1969.
[132] par 20.
[133] par 21.
[134] par 22.
[135] par 24 – 27.
[136] par 29.
[137] Du Plessis *Re-interpretation of Statutes* (2002) 156-158; Devenish *Interpretation of Statutes* (1992) 163-165.

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section 154(2), namely that pre-commencement debts would be discharged on implementation of the business rescue plan, is presumably only available if the plan provided for such discharge and the business rescue practitioner obtained the consent of the relevant creditors. To consider section 154(2) on its own and without giving meaning to section 154(1) would be contrary to this presumption.

A business rescue plan that attempts to provide for the discharge of debts without the consent of the affected creditor would not be a valid plan. To hold otherwise would make a mockery of the phrase "a creditor who has acceded to the discharge" in section 154(2).

### 6.3 Procedural irregularities and the termination of the business rescue proceedings

Section 129(5)(*a*) of the act provides that if a company fails to comply with the procedural requirements in section 129(3) and (4) its resolution to begin business rescue proceedings would lapse and is a nullity. There has been uncertainty whether this happens by operation of law or whether the court's intervention is necessary before the proceedings will terminate. In *Panamo Properties (Pty) Ltd v Nel NNO*[138] the supreme court of appeal has put this uncertainty to rest.

In this case the applicants argued that non-compliance leads to the automatic nullification of the resolution to commence business rescue, which would imply that an order in terms of section 130 of the act would not be necessary. They would not have been able to commence proceedings in terms of section 130, because a business rescue plan had already been adopted. Furthermore, since the applicants were also the directors of the company, they would arguably not have standing to bring the proceedings in terms of section 130.

There are two important rulings in this judgment. First, section 132(2)(*a*)(i) provides that business rescue proceedings are terminated when a court makes an order in terms of section 130(5)(*a*). The business rescue proceedings are not terminated before this point, even if the resolution to initiate the proceedings were a nullity.[139]

Secondly, when there is non-compliance with a procedural aspect as set out in section 129(3) and (4) the court retains an overarching discretion to condone the irregularity and to refuse to set aside the resolution. Section 130(5)(*a*) provides that the court may set aside the resolution on the grounds set out in subsection 1, *or* if having regard to all the evidence, the court considers that it is otherwise just and equitable to do so. The court held that this "or" should have read "and" and rejects a contention that it provides a fourth ground for the setting aside of the resolution.[140] Rather, it provides that the court must be satisfied over and above the non-compliance with the requirements set out in section 129(3) and (4) that it is just and equitable to set aside the resolution.

When read in this manner, technical irregularities in complying with the mentioned sections will not lead to the invalidity of the business rescue proceedings. Furthermore, it will guard against a situation, such as presented itself in this case, where the persons behind the corporate veil are manipulating the procedure for their own benefit.

This judgment and the clarity it introduces is welcomed. It has already been followed by the same court in *Newton Global Trading (Pty) Ltd v Da Corte*.[141]

138 2015 5 SA 63 (SCA).
139 par 28.
140 par 30 – 32.
141 2015 JDR 2652 (SCA).

### 6.4 Suspension of liquidation proceedings

In *Richter v ABSA Bank Ltd*[142] the supreme court of appeal confirmed that an application for business rescue may be brought at any time before the final winding-up of the affairs of the company. It overturned the decision of the court a quo that an application for business rescue could not be brought after the final liquidation order had been granted.[143]

The court relied on section 136(4) of the act, where it is envisaged that the liquidator would be a creditor of the company for any outstanding amounts owing to him or her for work done during the liquidation proceedings that preceded a business rescue. "Liquidator" refers to both a provisional liquidator and a final liquidator in terms of the Companies Act 61 of 1973.[144]

It is foreseeable that circumstances may arise after the commencement of liquidation proceedings that could return a prospect of rescue to an ailing business.[145] The court acknowledged the practical difficulties that a late intervention of business rescue could pose, but declined to rule out a suspension of liquidation in all instances.[146] Rather, these considerations are open to be considered by a court in deciding the merits of an application for business rescue in such circumstances.

The court in *Standard Bank of South Africa Ltd v A-Team Trading CC*[147] held that an application for business rescue suspends an application for provisional liquidation. On an ordinary reading of section 131(6) of the act an application for business rescue would suspend "liquidation proceedings", which would include an application for provisional liquidation. Ordinarily, the application for provisional liquidation will be postponed to be considered together with the application for business rescue so that the alternative order may be granted if the application for business rescue is unsuccessful.

Unfortunately, that is as far as I can agree with this judgment. It went on to hold that the moratorium on legal proceedings and the protection of property interests also commences on the application for business rescue in this case. This result from an erroneous reliance on section 132(1)(*b*) of the act, initiation applied for by an affected person, as determining the time of commencement of the business rescue. Where, as in this case, an application for provisional liquidation preceded an application for business rescue, I submit that the key provision in this enquiry ought to have been section 132(1)(*c*), which states that business rescue proceedings begin when a court makes an order placing a company under supervision during the course of liquidation proceedings. I submit that the context of section 132(1) indicates that subsection 1(*c*) applies in all cases where liquidation proceedings are to be suspended, meaning that the legal moratorium does not affect the application for provisional liquidation until the order for business rescue is granted.

142 2015 5 SA 57 (SCA).

143 For criticism of this judgment, see Van der Linde "An overview of recent company law cases: a mixed bag of emerging clarity, lingering doubt and deepening confusion" 2015 *Annual Banking Law Update* 60 75; Locke and Esser "Corporate law (including stock exchanges)" 2014 *Annual Survey of South African Law* 216 232; Delport, Vorster, Burdette, Esser and Lombaard *Henochsberg on the Companies Act 71 of 2008* (Service Issue 12, 2016) 478.

144 s 1(1) and sch 5(9).

145 par 15.

146 par 16.

147 2016 1 SA 503 (KZP).

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The same mistake was in my opinion made in *Safari Thatching Lowveld CC v Misty Mountain Trading 2 (Pty) Ltd*.[148] Here too an application for winding-up commenced before the launching of an application for business rescue. The court, in what I thought was a very innovative judgment, held that the moratorium applied from the moment that the application was launched by the affected person, in other words, that the business rescue commenced in terms of section 132(1)(*b*). However, since it could grant leave to proceed with legal proceedings in terms of section 133(1)(*b*), it held that the circumstances of the case before it were such that leave had to be granted.[149]

The court distinguished the facts before it from the facts in *Elias Mechanicos Building & Civil Engineering Contractors (Pty) Ltd v Stedone Developments(Pty) Ltd*.[150] In that case the legal proceedings had not yet commenced and the court held that leave to commence proceedings had to be granted in a separate application. In this case the proceedings had already commenced and the court held that it would lead to absurdity to require a separate application to proceed. This would include the interruption of trials already underway.[151] The court therefore held that it was competent to apply for the continuation of proceedings during the proceedings themselves.[152] The court accordingly granted leave to proceed with the winding-up application and granted the order.

As already indicated, I am of the view that the relevant time for the commencement of business rescue in the case of the suspension of liquidation proceedings, which includes applications for liquidation, is the time that the court grants the order for business rescue as provided for in section 132(1)(*c*). On this view the business rescue proceedings would not have commenced in the *Safari Thatching Lowveld CC* case and the moratorium would not yet apply. The outcome, however, would remain the same if the business rescue application were granted, namely the suspension of the liquidation proceedings. However, to avoid the unnecessary appointment of liquidators, I maintain that it remains practical to postpone the granting of a final winding-up order until the date that the application for business rescue is determined.[153]

### 6.5 Setting aside of the business rescue plan

In *ABSA Bank Ltd v Naude NO*[154] the supreme court of appeal held that the joinder of all the creditors of the company is necessary where there is an application for the setting aside of an approved business rescue plan.[155] The test is the same as in any matter where the court has to consider the suitability of joinder, namely whether “a party has a direct and substantial interest in the subject matter of the litigation which may prejudice the party that has not been joined”.[156] In this instance the creditors who have voted for the business rescue plan will be prejudiced if they are

[148] 2016 3 SA 209 (GP).
[149] par 26 – 28.
[150] 2015 4 SA 485 (KZD).
[151] par 23 – 24.
[152] par 26.
[153] See, for instance, the practice of Van der Linde J in the Gauteng Local Division, Johannesburg in *Pouroullis v Market Pro Investments 106 (Pty) Ltd (South African Bank of Athens Ltd and ABSA Bank Ltd Intervening Creditors)* 2016 JDR 0263 (GJ).
[154] (20264/2014) 2015 ZASCA 97 (1 June 2015). See further *Stalcor (Pty) Ltd v Kritzinger NO* (1841/2012) 2016 ZAFSHC 6 (21 January 2016) par 44.
[155] par 10.
[156] par 10 with reference to *Gordon v Department of Health, KwaZulu-Natal* 2008 6 SA 522 (SCA) par 9.

not joined. A prospective order may affect amounts that they expect to receive in terms of the plan and may affect amounts already received in terms of the plan.

## 7 *Winding-up*

In *ABSA Bank Ltd v Hammerle Group*[157] the supreme court of appeal confirmed that a creditor who entered into a subordination agreement is a contingent creditor and therefore has standing to initiate winding-up in terms of section 346(1)(*b*) of the Companies Act 61 of 1973.[158] The court further held that admissions of inability to pay its debts made during settlement negotiations, even if made "without prejudice", remain admissible as evidence of an act of insolvency.[159] It is namely in the public interest that insolvent companies must be prohibited from further trading, which warrants the exception of the privileged nature of such negotiations. The court confirmed a similar finding in *ABSA Bank Ltd v Chopdat*.[160]

*Roering NNO v Mahlangu*[161] affirmed that section 417 and 418 enquiries may be used to ascertain the merit of the institution or continuation of litigation by the liquidators of a company.[162] A narrower construction, namely that the enquiry should be limited to a reconstruction of the state of knowledge that the company should possess, was rejected.

A further argument before the court was that it constituted an abuse of the enquiry to allow the liquidators to gain insight into what a potential witness in a trial may say, or will be unable to say. This included a conclusion that the witness is somehow flawed or unreliable.[163] The court held that the nature of abuse would depend on the circumstances of each case. It would be an abuse to benefit a creditor of the company.[164] But fundamental in the enquiry into abuse is whether the enquiry is used for its intended purpose,[165] which the court was convinced it was in the present case. In keeping with the public interest in companies, and in finding out what caused the failure of a company in a particular case, abuse will not be readily inferred.[166] Evidence obtained from a witness in an enquiry will also often be inadmissible in subsequent civil proceedings, which provides a safeguard against abuse.[167] In this case, the court was not convinced of any abuse.

Note that the correct procedure to challenge the summoning of a witness by a commissioner is by means of judicial review and that disputed decision is that of the commissioner and not of the liquidators, as was alleged in this matter.[168]

In *Diener NO v Minister of Justice*[169] the business rescue of a close corporation was terminated and replaced by liquidation. The business rescue practitioner used the services of a firm of attorneys during the proceedings to stay the sale in execution of immovable property over which First National Bank held a mortgage. In the

[157] 2015 5 SA 215 (SCA).
[158] par 9.
[159] par 13.
[160] 2000 2 SA 1088 (W) 1092H – 1094F.
[161] 2016 3 All SA 466 (SCA).
[162] par 33.
[163] par 34.
[164] par 36.
[165] par 37 – 38.
[166] par 39.
[167] par 40.
[168] par 52.
[169] 2016 JDR 0632 (GP).

subsequent winding-up of the close corporation the business rescue practitioner did not prove the claim of his outstanding remuneration against the estate. This claim was not reflected in the final liquidation and distribution account at all. The claim for the attorney's fees was proven against the estate, but the liquidation and distribution account included it as a claim against the free residue.

The Master was approached to resolve a dispute between the liquidators about the treatment of these claims in the account. At issue in this case were two of these disputes. First, it had to be determined whether the claim by the attorneys should have been deducted as an administration fee from the encumbered asset account or whether it was a charge against the free residue. Secondly, it had to be determined whether the business rescue practitioner had to prove a claim against the estate for the remuneration left outstanding after business rescue or whether this was not necessary.

The Master held that the attorney's fees had to be considered costs of administration of the liquidation in terms of section 97 of the Insolvency Act.[170] It was further held that sections 135(4) and 143(4) of the Companies Act did not provide that the costs of the business rescue practitioner would be deemed costs of administration in the liquidation. Furthermore, section 97 of the Insolvency Act determines which costs of administration may be deducted from the free residue. The costs of the business rescue practitioner therefore had to be proven.

This decision of the Master was taken on review by the business rescue practitioner. It was argued that the attorney's fees constituted expenses of the business rescue, which had to be included as protected post-commencement financing in terms of section 143. The applicant contended that his fees as business rescue practitioner had to be paid in the liquidation as a super-preference before all secured and unsecured creditors of the close corporation.[171]

The court confirmed the decision of the Master on both disputed aspects. Section 135(4) clearly states that the post-commencement claims in business rescue shall be paid after claims arising out of costs of liquidation. Costs of liquidation are dealt with in section 97 of the Insolvency Act, which clearly state that they are payable from the free residue.[172] Since the business rescue practitioner did not prove his claim against the estate he was not entitled to any remuneration.

Two issues must be highlighted here. First, the attorney's fees are expenses of business rescue and must enjoy the post-commencement financing protection offered in section 135. Secondly, there are indications in the judgment that some of the parties considered the commencement of the business rescue as the commencement of winding-up proceedings.[173] This is not correct and one cannot see on what principle such a finding would be based. It is therefore incorrect to bundle the costs of business rescue together with the costs of liquidation. The latter has to be paid first, after which a second class of costs need to be deducted – the expenses from business rescue. This is what section 135(4) provides when it states that the preference in terms of the section will remain in force if business rescue proceedings are superseded by liquidation, *except to the extent of any claims arising out of the costs of liquidation*. The section does not provide that the post-commencement claims would be costs of liquidation.

[170] par 28 – 29.
[171] par 38.
[172] par 57 – 60.
[173] par 37.

# The Banking Amendment Act, 2015 and corporate governance in Zimbabwe's banking and financial services sector: a legal perspective

BATANAI TIRIVAMWE CHOKUDA*

## 1 *Introduction*

Zimbabwe, through the enactment of the Banking Amendment Act, 2015 (BAA), has overhauled the legal framework governing the business of banking in Zimbabwe. It has amended the Banking Act,[1] the Reserve Bank Act,[2] the Deposit Protection Corporation Act[3] and has repealed the Troubled Financial Institutions (Resolutions) Act.[4] Such a comprehensive overhaul of the legislative framework has been long overdue given the fact that the banking and financial services sector has been long riddled by scandals and the failure of local banking and financial services institutions.[5] Bank failure has been an almost constant feature of the banking and financial services sector landscape. It is fitting to consider whether these reform efforts will result in an improvement of the governance of financial institutions in the country.

This is by no means the first attempt in Zimbabwe to overhaul the regulation of the banking sector. The first major reform was under the auspices of the ESAP programme in the early 1990s. Zimbabwe liberalised and deregulated the sector and by so doing opened the proverbial Pandora's Box. The first indigenous bank to be issued with a licence was the United Merchant Bank and its demise just three years later heralded the dawn of an era of bank failures in Zimbabwe. It became the first of a series of bank failures since then.[6] To date 17 indigenous banks have failed since 1998. This failure rate has been nothing short of astounding and has been attributed to poor corporate governance coupled with concentrated ownership,

* LLB (UZ), LLM (Comm Law) Cape Town, LLD candidate (NWU).

1 Chapter 24:20.

2 Chapter 22:15.

3 Chapter 24:29.

4 Chapter 24:28.

5 Section 2 of the BAA, which amends section 2 of the Banking Act (Chapter 24:20), defines a "financial institution" as meaning any of the following: a banking institution, a building society, insurer, a fund registered in terms of the Pension and Provident Funds Act (chapter 24:09), the Small and Medium Enterprises Development Corporation, the Infrastructure Development Bank of Zimbabwe, a trustee or manager of a collective investment scheme registered in terms of the Collective Investment Schemes Act (Chapter 24:19), People's Own Savings Bank (POSB), Reserve Bank of Zimbabwe (RBZ), National Social Security Authority (NSSA) and the Sovereign Wealth Fund of Zimbabwe.

6 Nhavira, Mudzonga and Mugocha *Financial Regulation and Supervision in Zimbabwe* (www.zeparu.co.zw) 42.



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related party transactions (RPTs) and non-performing insider loans.[7] Such a high level of bank failure is an indictment on the governance and regulation of banking institutions in Zimbabwe, particularly the indigenous banks. Will the enactment of the BAA lead to an improvement of the governance of these institutions and a reversal of the bank failure trend?

### 1.1 Why does the governance of banking institutions warrant special attention?

Banking and financial services institutions play a critical and indispensable role in any modern economy's financial system and Zimbabwe is no exception.[8] They are essential to modern payment systems, industrial expansion mobilization and deployment of financial resources.[9] A weak banking system impedes economic growth and the converse is also true, a well-functioning banking system is a catalyst for economic growth.[10] This is especially so in the context of developing, transition and emerging economies such as Zimbabwe where capital markets are generally underdeveloped and banking institutions are consequently the chief providers of funding for corporate activities.[11] This significance to the well-being of an economy gives the governance of a banking institution a significant public character compared to other companies. This public character is reinforced by the fact that governments tend to bail out troubled banking institutions that pause a significant threat to the economy using public funds.[12] Consequently banking institutions are regulated to a far greater extent compared to non-banking companies. [13]

The provision of financial services in the modern world on the back of modern payment systems and advanced communications technology also has an inherent global character and accordingly, banks, especially large multi-national banking institutions, have a supranational reach. This supranational reach means that a bank failure can easily have an effect that is felt across borders as was illustrated by the calamitous collapse of Lehman Brothers in 2007, which precipitated the subprime mortgage crisis and plunged the global economy into a recession.[14]

The subprime crisis exposed excessive risk taking and speculation on the part of many banking and financial services institutions, and the fact that the crisis emerged from one of the most well-regulated economies not only exposed the weaknesses in the governance frameworks for the banking sector but also underscored the

[7] Nhavira, Mudzonga and Mugocha (n 6) 42; RBZ *Troubled Financial Institutions 2004-2005* 3; RBZ *Bank Supervision Report 2014* 37.

[8] RBZ *Annual Report 2005* 41.

[9] RBZ *Bank licensing, Supervisions and Surveillance 2005* 3; Ongore and Kusa "Determinants of financial performance of commercial banks in Kenya" 2013 *International Journal of Economics and Financial Issues* 237 238*;* Jimoh "Stewardship and corporate governance in the banking sector: evidence from Nigeria" 2012 *Accounting and Finance Research* 198*;* Levine "The corporate governance of banks: A concise discussion of concepts and evidence" 2004 *World Bank Research Working Paper No 3 404.*

[10] Nkowani "Supervision of banks and financial institutions in Malawi" (2008) *MLJ* 68; BIS *Principles for Enhancing Corporate Governance* (2010) 1.

[11] Fundanga "Corporate governance and its impact on financial institutions" 2011 Bank of International Settlements (BIS) Central Bankers' Speeches (https://www.bis.org) 1; Basel Committee on Banking Supervision 2014 (www.bis.org) 3.

[12] Betch, Bolton and Roell "Why bank governance is different" 2012 *Oxford Review of Economic Policy* 439.

[13] Cocris and Ungureanu "Why are banks special: an approach from the corporate governance perspective" 2007 *AI I Cuza University of Iasi Economic Series* 57.

[14] Wiggins, Piontek, Metrick "The Lehman Brothers bankruptcy" 2014 *Yale Programme on Financial Stability* 1.

centrality of banks to the stability of economies, and the need for convergence of the norms and rules that regulate the governance of banking institutions.[15] Efforts at such a convergence are currently underway in the SADC through efforts at harmonizing banking regulation and legislation through the development of the SADC Model Central Law, the establishment of the Committee of Central Bank Governors and the adoption of the SADC Protocol on Finance and Investment. Further, it requires a supranational approach where the regulation of the governance of banking institutions has to conform to some regional and international benchmarks such as the SADC Protocol on Finance and Investment and the Basel Accords and OECD Principles of Corporate Governance.

These considerations and other factors that set banking institutions apart from non-banking companies point towards a direction that a special corporate governance regime for banking institutions is warranted.[16] High standards of corporate governance practices in banking institutions are essential to maintaining the faith and confidence of the public in the financial system.[17]

### 1.2 What is corporate governance?

Before any discussion of the impact of the BAA standards on the conduct of banking business in Zimbabwe, it is imperative to clarify what corporate governance is. In spite of the prominence and widespread use of the term, corporate governance is not a notion that lends itself easily to precise definition. However, corporate governance comprises a set of rules and norms at the internal level of individual companies and the external regulatory framework that is characterised by external regulation.[18] Corporate governance is accordingly defined as:

> "a system, comprising of formal and informal rules, accepted practices, enforcement mechanisms, private or public that together govern the relationship between those in effective control of companies on the one hand and those who have invested in the company on the other hand."[19]

Bearing this definition in mind, this paper investigates whether the BAA will lay the necessary legal foundation for the improvement of corporate governance in the banking and financial services sector. This will depend in large measure on its impact on the internal management and governance systems of banking institutions and the external system of supervision and monitoring.

## 2 *Impact of the BAA on the internal governance systems and the board of directors*

Corporate governance reforms in the banking sector have largely focused on external systems of governance and insufficient attention has been paid to the internal systems

[15] Fundanga (n 11 (2011)) 1; Arun and Turner *Corporate Governance of Banks in Developing Economies: Concepts and Issues* (2004) (www.seed.manchester.ac.uk) 3; Jimoh (n 9 (2012)) 200; Levine (n 9 (2004)) 2; Alexander "UK corporate governance and banking regulation: the regulators role as stakeholders" 2004 *Stetson Law Review* 991.

[16] Levine (n 9 (2004)) 2.

[17] BIS *Principles for Enhancing Corporate Governance* (2010) 5.

[18] Zinca "Corporate governance of banks – present and perspectives" 2012 *Annals* Economics Science Series 278.

[19] Oman and Blume *Corporate Governance: A Development Challenge* (2005) (www.oecd.dev/indights) 1.

of corporate governance.[20] The board of directors is the keystone of an effective internal corporate governance system.[21] An improvement of the legal framework that governs external supervision and monitoring alone will not lead to an improvement of the governance of banking institutions. The major corporate collapses of recent years that were widely blamed on board mismanagement and have occurred across the globe, have compelled many countries to look again at the mechanisms of board management. If the BAA is going to succeed in improving corporate governance it must have a decisive impact on the boards of directors of banking institutions. It must lay the structures for the improvement of bank directors' conduct.

### 2.1 Legal duties of bank directors

The primary legal tools for regulating the conduct of directors at the internal level are the legal duties of directors. These duties constitute a significant component of the traditional corporate governance paradigm.[22] The overarching duty of directors is to act in good faith and to act always in the best interests of the company. In discharging that duty, a director must act with the necessary care and skill.[23] These legal duties of directors constitute the cornerstone of all corporate governance.[24] Traditionally bank directors, for the purposes of determining their legal duties, have been treated in much the same manner as the directors of other companies.[25] This is not surprising given the fact that the majority of banking institutions, globally, are organised in the form of public joint stock companies. Banks are for the most part just companies, no different, in terms of form and structure, from a company that, for instance, specializes in telecommunications or manufacturing. There are, however, critical differences between banking institutions and non-banking companies and as such the legal duties of directors of banking institutions should be treated differently from those of other companies.

The very wide discretionary powers, with limited checks, given to directors under the common law, are ill-equipped to regulate the conduct of bank directors.[26] The directors' legal duties were largely developed during a period when corporate organisations were relatively simple.[27] These common-law standards are increasingly being viewed as archaic, simplistic and modest, and ill-equipped to regulate directors' conduct in the modern commercial world, more so in the particularly

[20] Alexander (n 15) 992; Zongwe "Conjuring systemic risk through regulation by SADC central banks" 2011 *SADC Law Journal* 100; Macey and O'Hara "The corporate governance of banks" 2003 *FRBNY Economic Policy Review* 91; Das and Ghosh "Corporate governance in banking systems: An empirical investigation" 2004 *Economic and Political Weekly* 1236.

[21] Srivastav and Hagendorff "Corporate governance and bank risk taking" 2016 *Corporate Governance and International Review* 5.

[22] Mongalo "South Africanizing company law for a modern competitive global economy" 2004 *SALJ* 95 101.

[23] Benkink "An historical of the director's duty of care and skill: from the nineteenth century to the Companies Bill of 2007" 2008 *SA Merc LJ* 100.

[24] Havenga "Regulating directors' duties and SA company law reform" 2009 *TSAR* 184; Mongalo (n 22 (2004)) 101.

[25] De Jager *The Management of Banks in South Africa: Legal and Governance Principles* (2000 thesis SA) 17; Levine (n 9) 2.

[26] Botha"The role and duties of directors in the promotion of corporate governance: A South African perspective" 2009 *Obiter* 713; Mongalo "The emergence of corporate governance as a fundamental research topic in South Africa" 2002 *SALJ* 181; Mayanja "The proper role of shareholders in the decision making processes of modern large Australian companies" 2009 *Australian Journal of Corporate Law* 12.

[27] Cranston *Principles of Banking Law* (2002) 22.

complex world of the business of banking.[28] Incompetence, flagrant abuse of power, tax evasion, creative accounting and negligence may easily prevail in corporate management unless there are efficient legal devices to deter such conduct.

### 2.2 Impact of the BAA on bank directors' duties

There is obviously need for strengthening the standards of directors of financial institutions and the law has a significant role to play in this regard. In general terms, the law has four broad avenues to pursue in order to raise the standards of directors' conduct, compelling more comprehensive disclosure of directors' activities, introducing more demanding legal duties and restricting the power to exonerate defaulting directors.[29] From the codes of recommended practices that have been developed over the years, ideas such as having boards comprising a majority of independent non-executive directors, development and greater use of board committees,[30] strengthening disclosure and reporting requirements, developing statutory statements of directors' duties and a reconstitution of the legal duties of directors have emerged and are crystalizing as benchmarks in methods to improve board performance and to minimize mismanagement. Codes of recommended practices have served as an impetus for the revision of corporate legislation. Codes of recommended practices have had a transformative effect on the corporate governance landscape and carry the potential to enrich the content of directors' duties. Indeed, the King III report notes that:

> "There is always a link between good governance and compliance with law. Good governance is not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law. The starting point of any analysis on the topic is the duty of directors and officers to discharge their legal duties…"[31]

### 2.3 Codification of bank directors' duties

A much more accelerated way to achieve the reconstitution of bank directors' legal duties is through the partial codification of these duties in the main banking legislation. The BAA has taken such an approach and contains a statement on director's duties.[32] Codification of directors' duties is a controversial proposition that has much to commend and to condemn it. On the one hand, codification, in whole or partial can achieve greater clarity in the law, make it more comprehensible and affords lawmakers an opportunity to raise and strengthen the standards of directors' conduct. It also makes the law governing these duties more readily accessible as compared to the common law which is not readily accessible to people outside the legal fraternity.

On the other hand, traditionalists maintain that the law governing directors' duties was distilled by courts over a very long period of time and codification runs the risk of jettisoning the expansive body of law that has emerged through judicial precedent. It is further argued that the judge made law is flexible and more adaptable to changing times and codifying this area of the law would make it rigid

[28] Botha (n 26 (2009)) 713.

[29] Worthington "Corporate governance: remedying and ratifying directors' breaches" 2000 *Law Quarterly Review* 2.

[30] particularly the audit committee, risk management committee, nomination and remuneration committees.

[31] King II (2009) 6.

[32] s 20A of the BAA.

and make the courts focus on the letter of the statute rather than the principles and policy considerations behind the rules being codified.[33] Both arguments have their merits; however, the fact still remains that the common-law duties have lagged behind developments in the commercial world. Partial codification has emerged as the preferred choice of establishing a statutory statement on directors' duties.[34]

The statement reaffirms the common-law position that directors owe fiduciary duties, and the duty of care and skill, to the banking institution.[35] However, unlike the common-law position that essentially equated the best interests of the company to what is the best interests of the sum total of its shareholders, the BAA expands the scope of what constitutes the best interests of a banking institution by explicitly including the interests of the depositors.[36]

### 2.3.1 The duty of care and skill

With respect to the duty of care, skill and diligence, the common law required very little of directors. This is in sharp contrast to the manner in which the courts have vigorously and sometimes harshly enforced fiduciary duties. The approach was in the past so lax that it virtually gave directors the freedom to manage companies incompetently.[37] Essentially a director would be measured against herself. This is a very low bar especially in the context of the highly technical and complex world of banking. An apt illustration is the case of *Turquand v Marshall* where directors made a loan to one of their fellow directors who was subsequently declared insolvent and died in default of the loan. The court held that:

> "Whatever may have been the amount lent to anybody, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they chose unwise directors, but as long as they kept within the powers in their deed, the court could not interfere with the discretion exercised by them."[38]

The court was in essence saying that shareholders should bear the consequences of appointing inexperienced and unskilled directors. Taking into consideration the fact that the bulk of the resources to the disposal of banking institutions are depositors' funds, can the same standard be applied? It would defy logic to make the depositors bear the risk of the folly and possibly unscrupulous conduct of directors they had no hand in appointing.

The BAA jettisons the approach of measuring a director's level of skill and care against herself and replaces it with an objective standard of measuring bank directors against their peers. It introduces a notion of minimum qualifications, knowledge and skill by providing that a director must possess and maintain knowledge that may be reasonably expected of a person holding a similar appointment.[39] A higher standard is applicable depending on the level of knowledge and skill that an individual director may possess.[40] This is coupled with the requirements that

[33] Arden "Recent developments in directors' duties" 1999 *British Actuarial Journal* 912; Havenga (n 24 (2009)) 620.
[34] Havenga (n 24 (2009)) 621.
[35] s 20A(1) of BAA.
[36] s 20A(1)(a) of BAA.
[37] Finch "Company directors: who cares about skill about skill and care?" 1992 *Modern LR* 179; McLennan "Directors' duties and the 2008 Companies Bill" 2009 *TSAR* 186.
[38] (1886) LR 4 Ch App 376 386.
[39] s 20A(1)(c) of the BAA.
[40] s 20A(1)(d) of the BAA.

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the particulars and qualifications of a proposed principal have to be submitted to the Registrar for determination whether the proposed officers are fit and proper persons.[41] The BAA also addresses the issue of the quality of attention non-executive directors give to the banking institution or its holding company. The common-law approach to the question of attention to the affairs of a company is exemplified in the case of *Re City Equitable Fire Insurance Co Ltd* where it was held that:

> "A [non- executive] director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodic board meetings, and meetings of any committee of the board upon which he happens to be placed. He is not however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so."[42]

Non-executive directors are now widely seen as critical corporate governance functionaries with a monitoring and supervisory role over the executive directors. The manner in which a non-executive director is viewed today is a far cry from the *Re Cardiff Savings Bank* case[43] where the president of the bank who only attended one meeting in 38 years was exonerated of any negligence in the collapse of the bank. Independent non-executive directors enhance the functionality of the board, they serve as a source of advice, counsel and discipline and help to reduce self-serving transactions by management. The BAA seeks to strengthen the role of non-executive directors and has rightfully raised the bar of their conduct by departing from the lax common-law approach. It requires a director to attend at least three quarters of the board meetings held within a year and states that failure to do so will be regarded as failing to exercise the requisite level of diligence expected of a director of a banking institution.[44]

### 2.3.2 Conflict of interest and RPTs

The BAA explicitly provides that a director or principal officer has a duty to avoid a conflict of interest between his or her own interests and those of the institution, its depositors and shareholders.[45] The BAA has also introduced measures designed to ensure that directors disclose their assets and business dealings. On the appointment of a bank director, and thereafter annually, the director has to complete a prescribed form setting out his or her assets, business dealings and interests, and those of his or her spouse.[46] The CEO of the banking institution has the duty to ensure that the documents are available for inspection by the RBZ on demand.[47] However, it is not enough merely to have strict measures to disclose the interests of the directors. Robust measures are also needed to ensure that despite disclosing interests in certain transactions, those interests will still not influence decisions. By precluding shareholders holding a significant interest in a banking institution from being appointed as a principal officer will go a long way in curbing the inevitable conflict of interest that arises when a dominant shareholder is an executive officer of a financial institution or its holding company.

[41] s 15G(3)(c) of the BAA.
[42] (1925) Ch 407 427.
[43] (1892) 2 Ch 100.
[44] s 20A(4) of the BAA.
[45] s 20A (1)(b) of the BAA.
[46] s 20B(1) of the BAA.
[47] s 20B(2) of the BAA.

### 2.4 Liability for and disqualification of errant directors

The efforts to improve the standards of director conduct tend to pay insufficient regard to the motivating force of legal sanctions.[48] The law can provide disincentives to errant behaviour by strengthening remedies against defaulting directors and closing the gap for exoneration. This is especially important with respect to the duty to act within the confines of the directors' powers. Bank directors in the Zimbabwean context have displayed, in numerous instances, a blatant disregard for limitations against their powers imposed by statute law. No reform of the standards of bank directors' duties will be complete without addressing the issue of director liability.

The Companies Act contains provisions that are designed to deter reckless conduct on the part of directors. It imposes both civil and criminal sanctions for carrying on a business in a manner that is reckless, grossly negligent or with intent to defraud any person.[49] Previously the Banking Act did not contain a similar provision and did not explicitly state whether section 318 of the Companies Act was applicable to bank directors. However, this position has now been altered by the BAA which explicitly states that section 318 of the Companies Act is applicable to bank directors. It further provides that where a banking institution has been placed under curatorship or judicial management or is being wound up directors can be held personally liable if they carry on the business of the banking institution, during this period, in a manner that falls below prudential norms and standards.[50] The Registrar and the CEO of the DPC may institute proceedings in terms of section 20(5) of the BAA and section 318 of the Companies Act to recover damages suffered by creditors and depositors.[51]

Errant directors tend to be repeat offenders and disqualification is a useful tool in deterring delinquent behaviour by preventing defaulting directors from simply moving to another company.[52] The BAA contains provisions aimed at preventing errant directors from holding similar posts. The Registrar is obliged to disqualify from appointment any person who used to be a director or principal officer of a banking institution or controlling company that was wound up, liquidated or placed under judicial management on the ground of failing to pay its debts.[53] The provisions contained in section 20A do not supplant the common-law or statutory provisions on directors' duties but merely adds to them. Consequently, provisions of the Companies Act continue to apply. For instance, the High Court of Zimbabwe is empowered by the Companies Act to disqualify from occupying the office of director any person that has been convicted by the High Court of any offence relating to the management of a company or has been convicted for reckless and grossly negligent trading or breach of fiduciary duty while an officer of a company.[54] Any person including the RBZ, Registrar and other regulatory agencies in the financial services can apply to the High Court for such an order to be issued.[55]

[48] Worthington (n 29 (2000)) 2.
[49] s 318(1) of the Companies Act (Chapter 24:03).
[50] s 20A(5) of the BAA.
[51] s 20A(6) (a) of the BAA.
[52] Cassidy "Models of reform: the directors' duty of care in a modem commercial world" 2009 *Stell LR* 378.
[53] s 11(1e) of the BAA.
[54] s 344(1) of the Companies Act (Chapter 24:03).
[55] s 344(2) of the Companies Act (Chapter 24:03).

### 2.5 Principal officers

The reforms regarding the duties of bank directors contained in the BAA would have been incomplete if banking institutions could continue to appoint as principal officers persons with questionable qualifications, skills and experience. Consequently, when it comes to the qualifications of the principal officers, the BAA goes further than the Banking Act in departing from the laissez faire approach of the Companies Act[56] which merely provides that a company shall have at least two directors. It imposes a minimum level of qualifications for bank directors.[57] It also limits the latitude of the banking institution to structure its management by prescribing certain principal officers namely the CEO, CAO, a Compliance Officer, and internal auditor.[58] It also makes it mandatory for banking institutions to appoint officers responsible for risk management, lending and credit administration, internal controls, investment and asset or liability management.[59] The BAA goes further to preclude a single individual from being appointed to perform two or more of the listed responsibilities.[60]

### 2.6 The compliance officer and the compliance function

The board of a banking institution and its controlling company will be obliged to establish an independent compliance function headed by the Compliance Officer.[61] The mandate of the compliance unit is to identify, assess and monitor compliance risk and advise the board of directors on ways to comply with all applicable laws, codes of conduct and standards of good practice.[62] The appointment of a compliance officer is of great significance. It clearly indicates the emphasis that is placed on the role of compliance. The Basel Principles recognise the independent compliance function as a critical component of a banking institution's second line of defence.[63] The board of directors is ultimately responsible for compliance, and the independent compliance function plays a critical role in supporting the policies and procedures that assist the banking institution to observe all the applicable obligations.[64]

The establishment of an independent compliance function in the new legal framework heralds a new approach of shifting from relying almost exclusively on external regulation to giving banking institutions greater responsibility in devising internal, self-monitoring systems and processes to comply with statutory and regulatory standards.[65] The BAA imposes on banking institutions and their controlling companies the responsibility to establish and maintain adequate and effective procedures of corporate governance consistent with the nature and complexity and risks inherent in their activities.[66] The internal systems should, inter alia, ensure that the principal officers of banking institutions or controlling companies adhere to corporate behaviour that is universally recognised and

[56] Chapter 24:03.
[57] s 20A(1)(c) of the BAA.
[58] s 20(2) of the BAA.
[59] s 20(2) of the BAA.
[60] s 13(3a) of the BAA.
[61] s 28B(1) of the BAA.
[62] s 28B(1)(b) of the BAA.
[63] BIS *2014 Corporate Governance Principles* (www.bis.org) 28.
[64] BIS (n 63) 28.
[65] Alexander (n 20 (2004)) 994.
[66] s 28A(1) of the BAA.

accepted as correct.[67] There is a vast plethora of judicial precedent on what constitutes acceptable conduct on the part of directors that has been developed over a relatively long period, mostly in Victorian England.

The traditional content of directors' duties has in turn been enriched by international benchmarks of recommended practices that have emerged in more recent times. The OECD Principles of Corporate Governance are widely regarded as the international benchmark and the Basel Principles as the predominant benchmark in the financial services sector. Locally, the National Code on Corporate Governance Zimbabwe (NCCG) is the recently promulgated benchmark. It is hoped that these will be used as benchmarks to measure the suitability and adequacy of the internal systems developed by banking institutions. In particular, the compliance officer has to be guided by the Basel Principles, the most recent being the 2014 corporate governance principles. One notable recommendation contained in the Basel Principles is that the compliance function must help educate staff about compliance issues and provide guidance to staff on the appropriate implementation of compliance laws, rules and standards in the form of policies and procedures. The compliance officer has a crucial role in the development of those internal systems and in ensuring that they comply with the proposed Act and any other enactments relating to banking institutions or controlling companies.[68]

### 2.7 Prescribed board committees

#### 2.7.1 Risk committee

It is now widely recognised that there is a need for establishing formal and systematic approaches to risk management especially in the financial services sector.[69] This is necessitated by the increasingly complex business environment marked by increased regulation, competition and rapid technological advances. Banking institutions face an enormous amount of risk, which carries the threat of contagion. Banking institutions and/or their controlling companies will be obliged to set up a risk committee whose membership shall comprise three or more members of which at least two shall be non-executive directors. The risk committee shall have a wide array of responsibilities which will, inter alia, include identifying and assessing risks to which the banking institution is exposed and to develop risk mitigation strategies.[70]

An independent risk management function is regarded as a crucial component of a banking institution's second line of defence.[71] Consequently the legal framework should ensure the independence of the risk committee and its access to all business lines of the banking institution. In this regard it is submitted that the independence of the risk committee would be better guaranteed if the language of the provision was to the effect that the membership should comprise a majority of non-executive directors who possess sufficient knowledge and experience in risk management.

The BAA does not make provision for the establishment of a remuneration committee. The area of executive compensation presents one of the most prominent instances of inherent conflict of interests between the interests of management and

[67] s 28A(2)(a) of the BAA.
[68] s 28A(2)(i) of the BAA.
[69] Ward "Exploring the role of the corporate risk manager" 2001 *Risk management* 7.
[70] s 28(C) of the BAA.
[71] BIS (n 63) 22; *National Code of Corporate Governance* (NCCG) (2014) 51.

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the company and its stakeholders at large. The Basel Principles recommend that significant financial institutions should have a remuneration committee as an integral part of their governance systems.[72] The National Code on Corporate Governance for Zimbabwe ("Zimcode") similarly recommends that companies should establish a remuneration committee to assist the board in setting and administering remuneration policies.[73] The absence of the requirement to establish remuneration committees constitutes a significant short-coming on the part of the BAA.

It is submitted that in the absence of a remuneration committee, risk management has to play a significant part in the determination of compensation packages for senior management. Executive compensation is inextricably connected to sound risk management and should be designed to promote the long term health of the organisation.[74] However, greater clarity is warranted and this is one area where some relatively detailed guidelines are necessary in the underlying legal framework.

### 2.7.2 The audit committee

The audit committee has the formidable task of overseeing the banking institution's financial control and reporting systems. An effective internal audit function provides an independent assurance to the board on the quality and effectiveness of a bank's internal control systems.[75] The Banking Act already provided for an audit committee and the BAA has only made a few adjustments. In terms of the proposed amendment, executive officers and employees of the banking institutions are precluded from appointment to the audit committee.[76] The audit shall, however, be headed by the internal auditor. The mandate of the audit committee is, inter alia, to establish appropriate accounting procedures and accounting controls in respect of the institution's business, to ensure compliance with the established financial control systems, to ensure the integrity and objectivity of financial statements and to select the external auditor.[77]

## 3 *Impact of the BAA on the external governance of the banking sector*

The BAA contains provisions that are designed to alter the landscape of external regulation and monitoring of banks in Zimbabwe significantly. Given that as many as 17 banking institutions have collapsed since 1998, it is clear that external supervision and monitoring in Zimbabwe has a dismal record. The regulatory agencies have repeatedly failed to detect irregularities in the operations of many banking institutions that eventually collapsed, at a time when the problems had become entrenched. The external supervision and monitoring function has failed to curb repeated manifestations of poor governance systems such as inadequate board oversight, inexperienced management or undue influence by dominant shareholders, non-performing insider loans, excessive risk taking, abusive RPTs and non-compliance with laws, and creative accounting, which have been repeatedly cited as being the chief causes of the numerous bank failures including the wave of bank failures in the 2003-2004 banking crisis. Is the BAA going to improve the external governance systems of the banking and financial services sector?

[72] BIS (n 63) 30.
[73] NCCG (n 71) 44.
[74] BIS (n 63) 30.
[75] BIS (n 63) 29.
[76] s 26(2) of the BAA.
[77] s 40(3) of the Banking Act.

### 3.1 Coordination between the financial services regulatory agencies

The financial services regulatory landscape in Zimbabwe is fragmented and follows the sectoral model of regulation. The financial services sector in Zimbabwe has five regulatory agencies and different sector specific legislation that governs the provision of financial services in Zimbabwe. This sectoral model of the regulation of the financial services industry, though followed by a number of countries, is inherently problematic. The widespread adoption of the financial conglomerate model[78] in Zimbabwe has exposed the limitations of sectoral regulation of the financial services sector. Financial conglomeration presents challenges to the effectiveness of traditional external monitory and supervisory mechanisms. Poor coordination between the regulatory agencies in Zimbabwe regulating these complex financial conglomerates has played a huge role in the overall ineffectiveness of the current external supervision model. Multiple institutions regulating different financial services provided by related companies are not capable of forming a holistic assessment of the risk profile of a financial conglomerate, and create space for regulatory arbitrage.[79] The RBZ itself has decried the limitations of the multi-institutional approach. It has noted that:

> "The weaknesses of the current regulatory arrangement where there are several regulatory agencies with limited formal arrangements to coordinate supervisory efforts create room for regulatory arbitrage and supervisory gaps in the financial sector." [80]

The legal framework that underpins the external governance system accordingly has to address the different risks facing core banking and other financial activities that may be provided by a conglomerate of related financial services companies comprehensively. Streamlining the number of agencies which regulate banking, securities trading and insurance is emerging as the preferred approach to regulate the increasingly complex landscape of financial services provision. This has been the regional trend. South Africa, through the Financial Sector Regulation Bill, is in the process of adopting and implementing the twin peaks[81] model of regulation. Zambia, consolidated its financial services legislation with the enactment of the Banking and Financial Services Act (Chapter 387) and has largely concentrated the monitoring and supervision of financial services providers in the Bank of Zambia. Malawi has similarly consolidated its financial services legislation through the Financial Services Act 26 of 2010. Internationally, Australia, which pioneered the twin peaks model, and the United Kingdom are leading examples of countries that have consolidated and streamlined regulatory agencies.

Zimbabwe, contrary to regional and international trends, has elected to retain its multiple institution sectoral model. An earlier draft of the Banking Amendment Bill was more robust and proposed a more integrated approach to the monitoring

[78] Financial conglomeration blurs the boundaries between different financial services such as banking, insurance and securities trading. Financial conglomerates are often complex institutions with multiple regulated and unregulated financial and other entities.

[79] National Treasury Department *Twin Peaks in South Africa: Response and Explanatory Document* 7.

[80] RBZ (n 8) 41.

[81] It is a model pioneered by Australia that comprises two equal and independent regulatory agencies, namely, the Australian Investment Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). The former agency is responsible for market conduct and consumer protection and the latter is responsible for financial system stability. The model has gained popularity across the globe and has been implemented in the UK.

and supervising of financial institutions than the version that was signed into law. A Financial Sector Oversight Council and a Finance Sector Stability Committee were going to oversee the monitoring. This would have established the supervision, coordination and collaboration between the regulatory agencies. However, these initiatives were jettisoned in the final version and replaced by somewhat watered down provisions which merely provide for the co-operation of supervisory and monitoring efforts by the Registrar and the RBZ.

The benchmark is that the legal framework for the supervision of financial institutions should grant the necessary power and authority to supervisors to enable sufficient and effective cooperation, coordination and information sharing amongst supervisors in order to facilitate group-wide supervision. The BAA has fallen short of this benchmark because it makes inadequate provision to foster greater cooperation and collaboration between the five regulatory agencies. Since Zimbabwe has retained a sectoral approach to regulation, a much more robust approach to co-operation between the regulatory agencies should have been preferred. In order for the retention of the sectoral regulatory model to be efficient and to minimize avenues of regulatory arbitrage, it has to be coupled with mechanisms that encourage greater cooperation, information sharing and effective coordination between the regulatory agencies. Merely providing that the Registrar and the RBZ co-ordinate their regulatory efforts is woefully inadequate.

### 3.2 Minimizing concentrated ownership and owner-management

Concentrated ownership and owner-management has been a major factor that has contributed to poor governance and the resultant collapse of many indigenous banking institutions in Zimbabwe.[82] The BAA has introduced a number of measures designed to eliminate and prevent the concentration of ownership in Zimbabwe's banking sector. The BAA imposes a cap on the extent of shareholding that can be held by an individual or controlling company in a banking institution. No individual can own shares in a banking institution or its controlling company that exceed 25%.[83] The same restriction applies to artificial persons with the exception that certain financial institutions, registered controlling companies and foreign financial services institutions that have been approved by the Registrar can have a shareholding greater than 25%.[84] Any shareholding that is in contravention of the foregoing requirements will essentially be rendered a nullity as the Registrar can prohibit the exercise of the voting rights on the shares or the accrual of any dividends payable on the shares. The Registrar also has the power refuse to register or cancel a controlling company's registration.

These requirements to register shareholders with significant interests combined with the restrictions on the use of nominee shareholding and limitation of share ownership by individuals to 25%, will reduce the likelihood of dominance by a single shareholder. These measures are also reinforced by the extensive powers that have been given to the Registrar of Banks. Firstly, the Registrar has the power to compel a shareholder who breaches the requirements to divest himself of his shares in the banking institution.[85] The Registrar can also, if he or she is satisfied that the shareholder has unlawfully or improperly influenced a decision of the board of

[82] RBZ (n 7 (2004-2005)) 16.
[83] s 15A(1)(a) of the BAA.
[84] s 15A(1)(d) of the BAA.
[85] s 15B(8) of the BAA.

a banking institution or any of its principal officers, compel that shareholder to divest himself of his shares.

The BAA also seeks to create an enforced separation between ownership and management of banking institutions. Owner-management of banking institutions in Zimbabwe has facilitated abusive transactions and misappropriation of depositors' funds that culminated in the collapse of many an indigenous banking institution. The BAA precludes banking institutions and their controlling companies from appointing as a principal officer, any person who holds, either directly or indirectly, a significant interest in the banking institution.[86] This will ensure a rigid separation between ownership and control. These measures, if fully implemented and enforced in a robust manner will go a long way in reducing the corrosive influence of dominant shareholders and will reinforce the ability of bank directors to act independently and in the best interests of the banking institutions and not the narrow interests of its dominant shareholders.

### 3.2.1 Regulation of bank controlling companies and dominant shareholders

The BASEL Principles of the Supervision of Financial Conglomerates provides that the legal framework for the supervision of financial conglomerates should equip supervisors with the necessary powers and authority to enable comprehensive group-wide supervision. The pre-BAA regulatory landscape was inherently ill-suited to provide an effective legal framework for comprehensive and effective group-wide supervision and monitoring of financial services conglomerates or banking institutions that are held by a separate holding company. Controlling shareholders could simply avoid the more rigorous regulatory regime of banks by being a controlling shareholder and executive director in the controlling companies.

The BAA seeks to plug this avenue for regulatory arbitrage by a raft of provisions that are designed to regulate companies and individuals controlling banking institutions closely. Controlling companies are now required to register with the Registrar. In its application for registration, the company has to furnish the Registrar with full particulars of its directors and officers and every shareholder controlling five or more percent of the company's voting stock. The Registrar will determine whether the directors and specified shareholders are fit and proper persons. In addition to this, it is now mandatory for any person, natural or artificial, who wants to acquire a significant interest in a banking institution or its controlling company to apply for approval from the Registrar.

The BAA prohibits the acquisition of or the exercise of control over a banking institution without the approval of and registration by the Registrar. It imposes a duty on banking institutions and their controlling companies to prevent a shareholder from acquiring a significant interest without the approval of the Registrar. The restriction covers cases where an individual in a banking institution or its controlling company combined with that of a close relative amount to five or more percent of the voting stock. In the case of a body corporate, if it and an associate together control five or more percent of the banking institutions or controlling company's voting stock, it is deemed to have acquired a significant interest. Further, the BAA also restricts the use of nominee shareholders and prohibits banking institutions from registering or transferring shares other than in the name of intended beneficiary.

[86] s 12(3a) of the BAA.

### 3.3 Role of the Registrar of Banks in the external governance of banking institutions in Zimbabwe

It is clear that the Registrar will play a pivotal role in the external governance system of banking institutions in terms of these new amendments to the regulatory framework for the banking and financial services industry. The Registrar will be cardinal in the prevention of concentration of ownership in the banking sector. The Registrar will have wide discretionary powers in many matters. For instance, the Registrar, upon application, has the discretion to permit a shareholder to hold more than 25% of the shares of a banking institution if satisfied that the shareholding will not be contrary to the public interest, the interests of banking institution concerned and its depositors.[87]

Certain quarters in the financial services sector have raised concerns that there are limited checks and balances to the exercise of these wide discretionary powers and that they may be abused. The BAA has put in place certain constraints on the exercise of the Registrar's discretionary powers. Firstly, the Registrar has to observe the principles of natural justice in making decisions that are likely to affect the rights or interests of any person and shall afford such persons clear notice of the nature of the decision considered and provide the person concerned with an opportunity to make representations regarding the matter. So, for instance, if the Registrar decides to order compulsory disinvestment of shares, the Registrar has to afford the affected shareholder an opportunity to make representations regarding the matter before a final decision can be made.

If the Registrar is to permit a shareholding in excess of 25%, the Registrar has to be satisfied that the shareholder in question is a fit and proper person and in the case of a juristic person, the Registrar has to be satisfied that the persons in control of that entity are fit and proper.[88] However, the BAA fails to provide any guidelines as to how the Registrar will determine what constitutes a fit and proper person. This glaring short-coming leaves the exercise of discretion too open-ended and susceptible to the possibility of abuse and cronyism. However, if granting permission for shareholding in excess of 25% would result in a change of control of the banking institution or its controlling company, the Registrar would have to seek the approval of the Minister through the Governor of the RBZ.[89]

The RBZ governor has the authority to give general directions of policy to the Registrar subject to the caveats that those directions must be in writing and must be approved by the Board of the RBZ. However, outside the policy directions given to the Registrar in terms of the BAA, the Registrar has complete autonomy and shall not be subject to the direction or control of the RBZ Governor and the RBZ.[90] It appears that the safeguards against abuse of the wide discretionary powers of the Registrar appear inadequate. Considering that concentrated ownership and domineering shareholders have been a significant problem in Zimbabwe's banking and financial services sector and has led to the collapse of many banking institutions, more robust safeguards are required in order to keep incidences of concentrated ownership in the financial services at the barest minimum.

[87] s 15A(2) of the BAA.
[88] s 15A(2) of the BAA.
[89] s 15A(3) of the BAA.
[90] s 4A(3) of the BAA.

## 4 *Conclusion and recommendations*

The BAA is poised to transform the governance landscape in Zimbabwe's financial services sector. The new legal framework contains provisions that are designed to improve both the internal and external governance systems of financial institutions in the country.

The BAA has not only focused on strengthening the external governance systems but will provide a more robust framework for the strengthening of the internal governance systems. By prescribing the principal officers, board committees and their functions it ensures not only that there will be uniform management structures in banking institutions, but also that key areas such as compliance with laws and governance best practices, risk management and the audit function will take place.

The codification of directors' duties will not only clarify the duties of directors and make them more readily available but will also explicitly extend their scope of application to include depositors. The bar on the standard of the care and skill expected of bank directors will be raised by adopting the more objective approach of measuring the director's level of care and skill against other directors occupying similar positions. This will be buttressed by the explicit incorporation of section 318 of the Companies Act which provides for the institution of proceedings against directors in their personal capacity for reckless trading but by also extending the ambit of what constitutes reckless trading in the financial services business.

The internal governance system will be aided by the comprehensive provisions aimed at enforcing a rigid separation of ownership and management of financial institutions. This will severely curtail RPTs and other problems caused by concentrated ownership. Concentrated ownership and the resultant dominant shareholder has been a major factor behind the collapse of many banking institutions in the country. The prohibition of shareholders holding significant interests from becoming directors or principal officers in banking institutions and their holding companies will eliminate incidences of owner-managers who simply misappropriate depositors' funds for personal ends. The inclusion of holding companies within the regulatory ambit of the financial services regulatory agencies and imposing similar standards of legal duties on the directors of banking institutions and their controlling companies, is an improvement that carries the potential to reduce the avenues of regulatory arbitrage.

Regulatory overlaps and poor coordination amongst the regulatory agencies had greatly limited the effectiveness of the external governance systems in the past. Considering that most banking institutions in the country are structured as financial conglomerates, a more coordinated and integrated approach to external monitoring allows the regulatory authorities to be able to form a broader and more holistic view of the financial sector and ensures that they are better placed to anticipate risks and trouble spots. The retention of the sectoral structure of the regulatory framework and multiple regulatory agencies might hamper the effectiveness of the reforms spearheaded by the BAA.

However, the holy grail that will ensure the success of the reform efforts spearheaded by the BAA, is enforcement. Laws are only as good as their enforcement and without a robust external governance system the internal governance systems have limited chance of improving overall corporate governance standards. The quality of external governance is the bedrock upon which the quality of corporate

governance is developed from and dependent upon.[91] Indeed, Sir Adrian Cadbury observed that:

> "… the actions which corporations take to improve their internal governance cannot make up for deficiencies in the external framework, notably if an appropriate and enforceable legal system is lacking …"[92]

Consequently, the efforts to improve corporate governance in Zimbabwe's banking sector to a great extent hinges on the improvement of the quality of the external governance framework, not only in the context of banking and the financial services sector but across the board. The quality of political governance is essential to the proper governance of companies. The establishment of a good legal system is key to the development of effective underlying laws and enforcement.[93] The quality of political governance has a direct impact on the effectiveness of the legislature, regulatory agencies and the judicial establishment which are key corporate governance institutions. Although the BAA has laid a legal foundation that carries the potential for improvement in Zimbabwe, the improvement of the governance of banking institutions cannot be divorced from the effects of the general political context in terms of which these reform efforts are being made and are to be implemented.

[91] Angou *Corporate Governance in Africa: The Record and Policies for Good Corporate Governance* (2001) (http://www.afdb.org) 325; Cadbury *Financial Aspects of Corporate Governance* (1992) (www.ifc.org).

[92] Cadbury (n 91).

[93] Allen "Corporate governance in emerging economies" 2005 *Oxford Review of Economic Policy* 167; Oman, Fries and Buiter *Corporate Governance in Developing, Transition and Emerging-Market Economies* (2003) (http://www.oecd.org) 33.

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# General update on the law of demand guarantees and letters of credit

MICHELLE KELLY-LOUW*

## 1 *Introduction*

About ten years ago, it could easily be said that South Africa had limited literature and case law available on demand guarantees, standby letters of credit and even commercial letters of credit. As English law has had a significant influence on the development of South African banking law in general, and particularly its letter of credit law,[1] the South African courts therefore often look at the English courts for guidance when dealing with these commercial instruments. The notion that South Africa has limited literature and case law dealing with letters of credit and demand guarantees is, however, no longer completely true. In the last couple of years, South Africa has seen an increase in the cases and literature dealing with these instruments, particularly demand guarantees. The last year was no exception, and more cases dealing with these commercial instruments, specifically demand guarantees, followed.

A "demand guarantee" is typically a short and straightforward instrument issued by a bank, other financial institution or insurance company under which the obligation to pay a beneficiary a fixed or maximum sum of money arises merely upon the making of a demand for payment in the prescribed form and occasionally also the presentation of documents as specified in the guarantee within the period of validity of the guarantee.[2] The International Chamber of Commerce defines a demand guarantee in art 2 of its 2010 Uniform Rules for Demand Guarantees ("URDG 758")[3] as "any signed undertaking, however named or described,

* BIuris LLB LLM LLD (Unisa) & Dip Insolvency Law and Practice (SARIPA) (UJ). Professor of Law, Department of Mercantile Law, School of Law, University of South Africa.

1 Van Niekerk and Schulze *The South African Law of International Trade: Selected Topics* (2006) 273; Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees: The Main Exceptions to the Autonomy Principle* (2009) 19–20; Hugo "Documentary credits and independent guarantees" ABLU 2005 (a paper delivered at the 2005 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 20 April 2005) (unpaginated) at 1 of his article.

2 Hewetson and Elliott *Banking Litigation* (2011) 243.

3 See *ICC Publication* No 758, Paris (2010).



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providing for payment on presentation of a complying demand".[4] A complying demand[5] under a demand guarantee is described in the URDG 758 as:[6]

> "a presentation that is in accordance with, first, the terms and conditions of that guarantee, second, these rules [ie, URDG 758] so far as consistent with those terms and conditions and, third, in the absence of a relevant provision in the guarantee or these rules, international standard demand guarantee practice".

Demand guarantees, standby letters of credit and commercial letters of credit are often used in local and international trade, particularly international sale-of-goods contracts, and construction or engineering projects.[7]

The terminology concerning demand guarantees is very confusing and there is no actual consistency internationally.[8] Demand guarantees are also generally known as an "independent guarantees/undertakings", "default undertakings", "performance bonds/guarantees", or "construction guarantees".[9] One of the reasons for the confusion and inconsistent use of terminology is the number of different instruments which are in use nationally and internationally.[10] Another reason is because bankers, exporters and insurers rather than lawyers developed them.[11] The use of the terminology "guarantee" often causes confusion regarding the actual nature of a particular instrument.[12] Although the terminology "guarantee" is used in relation to these instruments, it should be remembered that the general term "guarantee" can comprise two vastly different devices: (1) the primary (independent/direct) guarantee and (2) the accessory (or secondary) guarantee.[13]

The primary (independent) guarantee, for example a demand guarantee and letter of credit, refers to a special instrument where the liability of the guarantor to

[4] Its predecessor, the 1992 Uniform Rules for Demand Guarantees (see *ICC Publication* No 458, Paris (April 1992) ("URDG 458'), in art 2(*a*) defined a demand guarantee as follows:

> "For the purpose of these Rules, a demand guarantee (hereinafter referred to as 'Guarantee') means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called the 'Guarantor') given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgment or an arbitral award) as may be specified in the Guarantee, such undertaking being given
> (i) at the request or on the instructions and under the liability of a party (hereinafter called the 'the Principal'); or
> (ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter 'the Instructing Party') acting on the instructions of a Principal
> to another party (hereinafter the 'Beneficiary')."

[5] A demand means "a signed document by the beneficiary demanding payment under a guarantee" (art 2 of the URDG 758).

[6] Art 2 of the URDG 758.

[7] Kelly-Louw (n 1) 3 and 9; Kelly-Louw "Construction of demand guarantees gone awry" 2013 25 *SA Merc LJ* 404 410.

[8] Hewetson and Elliott (n 2) 239. For a discussion of the confusion regarding the terminology, see Kelly-Louw (n 1 (2009)) 7–8; Kelly-Louw (n 7 (2013)) 408–409.

[9] Demand guarantees are sometimes also referred to as "standby letters of credit", even though the latter has a very different historical development than demand guarantee (for a brief discussion of this, see Kelly-Louw (n 1 (2009)) 100–103).

[10] Hewetson and Elliott (n 2) 240; Pierce *Demand Guarantees in International Trade* (1993) 4.

[11] Kelly-Louw (n 7 (2013)) 408.

[12] Hewetson and Elliott (n 2) 239–240.

[13] See Kelly-Louw (n 7 (2013)) 404–410 for a discussion of the differences between the primary (independent) guarantee and the accessory (or secondary) guarantee.

pay is normally not dependent upon default of a principal debtor. The guarantor of a primary (independent) undertaking promises or gives a primary (independent) undertaking to perform the principal's (customer's) obligation, irrespective of whether or not the principal's (customer's) obligation is enforceable.[14] If the payment obligation is of this nature, then the promise to pay will be enforceable whether or not that of the principal debtor is enforceable.[15] In this instance, the guarantor undertakes to pay the beneficiary a sum of money on the beneficiary's mere statement that the applicant (principal debtor) is in default to perform the underlying contract and no actual proof of default is required.[16] In a nutshell, a primary guarantee means that the guarantor must pay first, and then raise any argument between the parties about the underlying contract thereafter.[17]

In contrast, a traditional guarantee (or a true guarantee), which includes, for example a suretyship, refers to a payment or alternatively performance obligation triggered only by actual default on the part of the principal.[18] In the case of a traditional guarantee, the surety or guarantor undertakes that the principal debtor will perform his (the principal debtor's) obligation to the creditor (beneficiary) and that he (surety or guarantor) will be liable to the creditor (beneficiary) to pay a sum of money to the creditor (beneficiary) or, instead, to perform the principal debtor's obligations under the underlying contract following the failure of a party (applicant or principal debtor) to perform the underlying contract, provided the beneficiary is able to prove that the principal debtor had failed to perform his part of the contract and then only to the extent of the principal debtor's liability and subject to any defences available to the principal debtor.[19] Thus the surety's or guarantor's liability for the non-performance of the principal debtor's obligation is co-extensive (accessory) to the principal debtor's obligation.[20] Should the principal debtor's obligation turn out not to exist or, is diminished, void, or discharged so, too, is that of the surety or guarantor.[21]

The fundamental difference between a traditional guarantee (suretyship) and a demand guarantee is that the liability of the surety of the traditional guarantee is secondary, while the liability of the guarantor or issuer of the demand guarantee is primary.[22] The surety of the traditional guarantee is co-extensive with (accessory to) that of the principal debtor and, if default by principal debtor is disputed by the surety, the creditor must prove such default. Neither statement applies to demand guarantees.[23] The principle that underscores demand guarantees is that each contract is independent (autonomous). Specifically, the obligation of the guarantor/issuer of the demand guarantee is not affected by disputes arising from the underlying contract between the beneficiary and the principal/applicant

[14] Kelly-Louw (n 7 (2013)) 404.
[15] Hapgood (with contributions from Levy, Phillips and Hooley) *Paget's Law of Banking* (2003) 702. See also Bennett "Performance bonds and the principle of autonomy" (1994) *Journal of Business Law* 574 575.
[16] Furmston and Chuah (eds) *Commercial law* (2013) 381.
[17] Furmston and Chuah (n 16) 381.
[18] Goode "Abstract payment undertakings and the rules of the International Chamber of Commerce" 1995 39 *Saint Louis University Law Journal* 725 726.
[19] Furmston and Chuah (n 16) 381 and Hapgood (n 15) 701–702.
[20] Hapgood (n 15) 702.
[21] ibid.
[22] Hapgood (n 15) 730.
[23] ibid.

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of the demand guarantee.[24] If the beneficiary were to make an honest demand, it would not matter whether or not between himself and the principal/applicant he is entitled to payment. The guarantor would just have to make the payment, the principal/applicant would have to reimburse the guarantor/issuer, and any disputes between the principal/applicant and the beneficiary, including any claim by the principal/applicant that the drawing was in breach of the (underlying) contract between them, would have to be resolved in separate proceedings which would not involve the guarantor/issuer as a party.[25]

Due to the vast difference in nature between primary and accessory payment obligations, it is important to not only look at the name of a specific instrument, but also to consider the substance of the instrument in order to determine the precise legal category it falls into.[26]

The entire purpose of a demand guarantee, which may use the language of guarantees, is to create a primary (independent) obligation on the part of the maker of it, which may require no more than the making of demand in a specific form.[27] Generally demand guarantees are payable on first demand without any additional documents. A demand guarantee creates a binding obligation to pay against the simplest of demands by the beneficiary without any proof of any default by the principal on the underlying contract.[28] However, many demand guarantees require at least a written statement indicating that the principal is in breach/default.[29] The guarantor of a demand guarantee must pay if the documents presented with the demand for payment comply with the documents that are required to be submitted in the text of the demand guarantee. The guarantor's obligations are independent (autonomous) of the underlying contract between the beneficiary and the principal, which means that, theoretically, the guarantor is obliged to pay if proper complying documents are presented, even if the beneficiary and the principal have not stipulated that there is a default under the original underlying contract.[30]

A demand guarantee is issued because of an underlying contract, for example a construction or engineering contract, concluded between parties to the underlying contract (eg, contractor and sub-contractor). Although a guarantor (eg, bank or insurer) issues a demand guarantee following this underlying contract between the principal (applicant of the guarantee) and the beneficiary of the guarantee, the guarantor is not actually concerned with that underlying contract. The demand guarantee is independent (separate) from the underlying contract, and the rights and obligations the guarantee creates are independent of those arising from that contract.[31]

The demand guarantee is similar to the standby and commercial letter of credit. Demand guarantees, standby letters of credit and commercial letters of credit all constitute independent contracts.[32] In other words, the payment undertaking

[24] ibid.
[25] ibid.
[26] Hewetson and Elliott (n 2) 239.
[27] Hewetson and Elliott (n 2) 240.
[28] Penn 'On-demand bonds—primary or secondary obligations?' 1986 4 *Journal of International Banking Law* 224 224.
[29] See O'Brien "Letters of intent and demand guarantees" (1993) *ABLU* (a paper delivered at the 1993 Annual Banking Law Update held at the Indaba Hotel, Johannesburg) 134 159.
[30] De Ly "The UN Convention on Independent Guarantees and Stand-by Letters of Credit" (Fall 1999) 33 *International Lawyer* 831 832.
[31] See also Bennett (n 15) 575 and Dinnie "A pound of flesh" (2007) 15 *Juta's Business Law* 127 128.
[32] Malek and Quest *Jack: Documentary Credits: The Law and Practice of Documentary Credits Including Standby Credits and Demand guarantees* ( 2009) par 1.34 at 17.

in these instruments is independent of both the performance of the underlying contract (eg, a sale-of-goods or construction contract) between the applicant of the demand guarantee or letter of credit (eg, a buyer of goods or contractor) and the beneficiary of the letter of credit or demand guarantee (eg, a seller of goods or employer of the construction contract), and of the relationship between the applicant (eg, a customer of a bank or insurer) and the issuer of the letter of credit or demand guarantee (eg, bank or insurer).[33] The operation of these instruments will not be interfered with by courts on grounds immaterial to the guarantee or credit itself.[34] Therefore, a fundamental feature of documentary credit law and demand guarantee law is the independence of the credit[35] and demand guarantee[36] from their respective underlying contracts. [37] In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[38] Lord Denning MR stated that:[39]

[33] Goode "Abstract payment undertakings in international transactions" 1996 22 *Brooklyn Journal of International Law* 1 12; Malan "Letters of Credit and attachment *ad fundandam jurisdictionem*" 1994 *TSAR* 150 150–151; Schulze "Attachment *ad fundandam jurisdictionem* of the rights under a documentary letter of credit—some questions answered, some questions raised" 2000 63 *THRHR* 672 674; Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) par 9.1 at 354–357.

[34] *Themehelp Ltd v West and Others* 1996 QB 84 (CA) 89; Malek and Quest (n 32) par 1.34 at 17; 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) 2-3.

[35] See, eg, *Phillips and Another v Standard Bank of South Africa Ltd and Others* 1985 3 SA 301 (W) 304A–B and 304E–F; *Union Carriage and Wagon Company Ltd v Nedcor Bank Ltd* 1996 CLR 724 (W) 732; *Loomcraft Fabrics CC v Nedbank Ltd and Another* 1996 1 SA 812 (A) 815F–816C; *Dormell Properties 282 CC v Renasa Insurance Co Ltd and Others NNO* 2011 1 SA 70 (SCA) par 39; *Firstrand Bank Ltd v Brera Investments CC* 2013 (5) SA 556 (SCA) par 11; *Casey and another v First National Bank Ltd* 2013 4 SA 370 (GSJ) par 14–17 and 20; *Casey v Firstrand Bank* (608/2012) (2013) ZASCA 131 (26 September 2013) par 5–7, 12 and 14. See also Hugo *The Law Relating to Documentary Credits from a South African Perspective with Special Reference to the Legal Position of the Issuing and Confirming Banks* (1997) 174; Van Niekerk and Schulze *The South African Law of International Trade: Selected topics* (2011) 290, 294; Malek and Quest (n 32) par 1.34 and 8.17; Adodo *Letters of Credit: The Law and Practice of Compliance* (2014) 153.

[36] *Union Carriage* case (n 35) 731–732; *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd* 2010 2 SA 86 (SCA); *Petric Construction CC t/a AB Construction v Toasty Trading t/a Furstenburg Property Development* 2009 5 SA 550 (ECG); *Compass Insurance Co Ltd v Hospitality Hotel Developments (Pty) Ltd* 2012 2 SA 537 (SCA) par 14; *Basil Read (Pty) Ltd v Nedbank Ltd* 2012 6 SA 514 (GSJ) par 26, 28; *Dormell* case (n 35) par 39; *Casey and Another v First National Bank Ltd* 2013 4 SA 370 (GSJ) par 14–17, 20–22. See also Van Niekerk and Schulze (n 35 (2011)) 294; Malek and Quest (n 32) par 1.34 at 17–18, par 1.41 at 21; Bennett (n 15).

[37] The independence principle of commercial letters of credit, standby letters of credit and demand guarantees is also internationally acknowledged. See, for example, revised article 5-103(*d)* of the United States of America's Uniform Commercial Code; articles 3 and 4 of the 1993 version of the Uniform Customs and Practice for Documentary Credits (*ICC Publication* No 500, Paris (1993) ("UCP 500")); articles 4 and 5 of the 2007 version of the Uniform Customs and Practice for Documentary Credits (*ICC Publication* No 600, Paris (2006) ("UCP 600")); article 2(*b*) of the 1992 Uniform Rules for Demand Guarantees (*ICC Publication* No 458, Paris (April 1992) ("URDG 458")); article 5(*a*) of the 2010 Uniform Rules for Demand Guarantees (*ICC Publication* No 758, Paris (2010) ("URDG 758")); rule 1.06(*a*) and (*c*) of the International Standby Practices (*ICC Publication* No 590, Paris (October 1998) ('ISP98')); articles 2 and 3 of the United Nations Convention on Independent Guarantees and the Stand-by Letters of Credit (United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996)).

[38] 1978 1 QB 159 (CA).

[39] 1978 1 QB 159 (CA) 171.

> "[a]ll this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice."

Another principle applicable to demand guarantees and letters of credit, which is very closely connected to the independence these instruments, is their documentary nature.[40] This means that the documentary credit transaction and demand guarantee transaction are transactions in documents and in documents alone. In other words, if the documents that are required in terms of the credit or guarantee are presented according to the terms of the credit or guarantee, the guarantor or issuer is obliged to pay, and if the documents do not correspond to the requirements the guarantor or issuer is not obliged to do so.[41] The guarantor or issuer has the duty to pay only when the stipulated documents are presented within the period and in line with the other conditions in the credit or guarantee.[42] The guarantor or issuer does not have the obligation to authenticate the documents submitted.[43] The guarantor or issuer is also not in the least concerned with investigating the external facts, for instance the principal's (applicant's) default or breach in performance of the underlying contract or even the scope of the loss really suffered by the beneficiary as a result of the principal's default or breach.[44]

The independence principle, however, is not absolute and over time a limited number of exceptions to it have come to be acknowledged and accepted in practice. Consequently, in certain situations, the independence of demand guarantees and letters of credit may be ignored by the guarantor and courts and regard may be had to the terms and conditions of the underlying contract (eg construction contract).

[40] Although the principle of autonomy/independence and documentary nature of these instruments can be separately stated, they are actually so closely connected that they cannot be treated independently (Malek and Quest (n 32) par 1.34 at 17; Byrne (edited by JG Barnes) *The Official Commentary on the International Standby Practices* (1998) 26). For a discussion of the documentary nature of these instruments, see Kelly-Louw "The documentary nature of demand guarantees and the doctrine of strict compliance" (Part 1) 2009 21 *SA Merc LJ* 306, and (Part 2) 2009 21 *SA Merc LJ* 470; Kelly-Louw "The doctrine of strict compliance in the context of demand guarantees" 2016 49 *CILSA* 85. Internationally the documentary character of commercial letters of credit, standby letters of credit and demand guarantees is also confirmed. See, for example, art 5 read with art 4 of the UCP 600 (a similar provision was found in art 4 of the UCP 500, the predecessor of UCP 600); arts 14(*a*) and *(d)* of the UCP 600; rule 1.06(*a*) read with rule 1.06(*d*) and rule 4.08 of the ISP98; art 2(*b*) read with art 9 of URDG 458; arts 6 and 19*(a)* of URDG 758.

[41] Malek and Quest (n 32) par 1.34 at 17; Kelly-Louw (n 40 (part 1 2009)) 307. See also *OK Bazaars (1929) Ltd v Standard Bank of South Africa Ltd* 2002 3 SA 688 (SCA); *Denel Soc Ltd v Absa Bank Ltd* 2013 3 All SA 81 (GSJ) in par 51–52; *Casey and Another v First National Bank Ltd* 2013 4 SA 370 (GSJ).

[42] Chuah *Law of International Trade: Cross-border Commercial Transactions* (2013) 591; Malek and Quest (n 32) par 1.34 at 17.

[43] See, for example, art 15 of UCP 500 and art 34 of UCP 600.

[44] *Coface South Africa Insurance Co Ltd v East London Own Haven t/a Own Haven Housing Association* 2014 2 SA 382 (SCA) par 10. See Goode (n 18 (1995)) 735; Goode *Guide to the ICC Uniform Rules for Demand Guarantees* (*ICC Publication* No 510 (1992)) 19; Malan (n 33) 151; Eitelberg "Autonomy of documentary credit undertakings in South African law" (2002) 119 *SALJ* 120 122; Kelly-Louw (n 40 (Part 1 (2009)) 311.

Established fraud is internationally accepted as such an exception.[45] Besides fraud, there is no international consensus regarding other possible exceptions.[46] In some jurisdictions,[47] illegality in the underlying contract is also reasonably well established as an exception.[48]

The proper construction of a guarantee where a guarantor undertakes to pay on first written demand is very important, because it gives rise to three somewhat different issues.[49] These are:[50]

> "[F]irst . . . whether the contract is a suretyship or a demand guarantee. The second is whether, if the instrument is a demand guarantee, it requires the beneficiary to assert a breach of contract by the principal. This is a question of construing the guarantee. The third is whether the documents presented by the beneficiary comply with the terms and conditions of the guarantee. This raises the issue of the required degree of strictness of compliance."

The South African courts were recently faced with instances where they had to construe certain guarantees or words and/or terms used in them and, in doing so, a few of the same issues, mentioned above, arose. For instance, one court had to construe a guarantee in order to determine whether or not the instrument before it constituted a primary guarantee or an accessory guarantee. Other courts had to construe the terms and clauses of demand guarantees in order to determine whether or not the documents presented by the respective beneficiaries complied with the terms of the guarantees. In doing the latter, the courts also had to deal with arguments as to whether or not the doctrine of strict compliance applies to demand guarantees. In this contribution attention is given to recent South African cases dealing with these issues in demand guarantees. The cases dealing with demand guarantees are also important for standby and commercial letters of credit due to the similarity of demand guarantees to these letters of credit.

## 2 *Contract of suretyship v demand guarantee*

It is important to keep in mind that it is not the name, label, title or heading that is given to a payment obligation or undertaking that determines whether or not it

[45] Enonchong "The autonomy principle of letters of credit: an illegality exception?" 2006 *Lloyd's Maritime and Commercial Law Quarterly* 404 405; Malek and Quest (n 32) par 1.34 at 18, Chapter 9. For a fairly recent discussion of the fraud exception in South Africa, see Kelly-Louw "Limiting exceptions to the autonomy principle of demand guarantees and letters of credit" in Visser and Pretorius (eds) *Essays in Honour of Frans Malan: Former Judge of the Supreme Court of Appeal* (2014) 197–218.

[46] For instance, Singapore, Malaysia, and Australia accept that there are or may be other exceptions, besides fraud. For examples of some of these exceptions, see Kelly-Louw "Illegality as an exception to the autonomy principle of bank demand guarantees" 2009 42 *CILSA* 339 footnote 2 at 340–341; for a more detailed discussion, see Horowitz *Letters of Credit and Demand Guarantees: Defences to Payment* (2010). See also *Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture* (1672/2013) (2014) ZAGPPHC 695 (2 September 2014) where a court recently implied that there are also various other acceptable exceptions under the South African law.

[47] For a full discussion of illegality as a possible exception, see Malek and Quest (n 32) 412–429; Kelly-Louw (n 46 (2009)); Horowitz (n 46) Chapter 7.

[48] See also Kelly-Louw (n 45 (2014)) 200–201.

[49] Hapgood (n 15) 730.

[50] ibid.

is accessory or independent, but rather its substance and construction.[51] It cannot be assumed that guarantees issued by reputable banks with a name or title that appears to indicate a primary (or direct) payment obligation, for example the use of the term "independent guarantee" or "demand guarantee", will automatically constitute a primary (independent) guarantee, as the rights and duties of the different parties to any guarantee will always be determined by the actual wording of the guarantee in which the promise is expressed.[52] Distinguishing the demand guarantee from a traditional guarantee is a matter of construction.[53] Practice, however, has shown that this not always an easy task.[54] "Given the bluntness of the demand guarantee, courts are naturally slow to construe a guarantee as a demand guarantee without clear words to that effect".[55]

The South African courts have made it clear that they will only interpret a guarantee as constituting an independent (primary) guarantee where such an intention is evident on a proper interpretation of the guarantee overall.[56] If there is any ambiguity in the clauses of the guarantee it may lead to a conclusion that the intention was to create an accessory guarantee. The language used in the guarantee will be decisive. Should there be is any uncertainty regarding the nature of the payment obligation of a guarantor a court is generally more likely to construe it be accessory rather than independent in nature.[57]

It has been suggested that the following factors strongly suggest that a specific instrument is a demand guarantee:[58]

- it relates to an underlying transaction between parties in different countries (jurisdictions);
- it is issued by a bank;
- it has an undertaking to pay "on demand" (with or without the words "first" and/or "written");[59] and

[51] *Minister of Transport and Public Works, Western Cape, and Another v Zanbuild Construction (Pty) Ltd and Another* 2011 5 SA 528 (SCA); *Mutual and Federal Insurance Company Limited v KNS Construction (Pty) Limited* (208/2015) (2016) ZASCA 87 (31 May 2016). See also Kelly-Louw (n 7 (2013)) 404.

[52] Hugo "Documentary credits and independent guarantees" *ABLU* 2011 (a paper delivered at the 2011 Annual Banking Law Update held at the Indaba Hotel, Johannesburg on 4 May 2011) 116 129; Kelly-Louw (n 7 (2013)) 415.

[53] *Marubeni Hong Kong and South China Ltd v The Mongolian Government* 2004 2 Lloyd's Rep 198 (QB (Com Ct); Furmston and Chuah (n 16) 381; Hapgood (n 15) 702. For a discussion of the difference between primary payment obligations, such as demand guarantees and letters of credit, and accessory payment obligations, such as suretyhip guarantees, see Kelly-Louw (n 7 (2013)) 404–410.

[54] See, eg, *Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd* 1995 3 All ER 737; *Zanbuild* case (n 51); *List v Jungers* 1979 3 SA 106 (A) 118C–E; Furmston and Chuah (n 16) 381; Kelly-Louw (n 7 (2013)).

[55] Furmston and Chuah (n 16) 381. See also *Vossloh AG v Alpha Trains* (UK) Ltd 2010 EWHC 2443 (Ch).

[56] *Zanbuild* case (n 51).

[57] *Zanbuild* case (n 51); Kelly-Louw (n 7 (2013)) 415.

[58] Hapgood (n 15) 731.

[59] In *Esal (Commodities) Ltd and Reltor Ltd v Oriental Credit Ltd and Wells Fargo Bank NA; Banque du Caire SAE v Wells Fargo Bank NA* 1985 2 Lloyd's Rep 546 (CA) the English Court of Appeal interpreted the words "we undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance" to not require the beneficiary to prove a failure to perform. See also *Siporex Trade SA v Banque Indosuez* 1986 2 Lloyd's L Rep 146 (QB (Com Ct)); Hapgood (n 15) 731.

- it does not contain clauses excluding or limiting the defences available to a surety/guarantor.

However, these factors are not determinative,[60] but merely assist in the construction process.[61] It has correctly been pointed out that in construing guarantees, it should be borne in mind that it would be difficult for a demand guarantee to not make reference to: (1) the contractual performance for which the guarantee is security; and (2) the circumstances under which a demand may be made, for example default by the principal/applicant.[62] "A bare promise to pay on demand without any reference to the principal's obligation would leave the principal even more exposed in the event of a fraudulent demand because there would be room for argument as to which obligations were being secured".[63]

The English Courts take into consideration all the relevant surrounding circumstances (ie, the "matrix of facts" method) when construing commercial instruments. In *Rainy Sky SA v Kookmin Bank*[64] the English Supreme Court set out a modern approach to interpreting contracts (including demand guarantees), namely that the surrounding circumstances or "matrix of facts" must be taken into consideration in order to construe the contract where appropriate (eg, where a guarantee is vague) or to correct a clear drafting mistake such that literal interpretation will bring about an "uncommercial result".[65] Simply put, it means that if there are two possible interpretations when construing a commercial instrument, an English court is permitted to prefer the interpretation which is consistent with business common sense and to reject the other.[66] There, is however, "a danger of the court substituting its own judgment of the commerciality of the transaction for that of the parties or, indeed, the industry".

The South African courts follow a similar modern method of interpreting contracts, including commercial instruments.[67] The general rule in South Africa of construing the common intention of the parties to a contract is to consider the "language" used in the contract. Generally, words and phrases in a contract are given their ordinary grammatical meaning as it appears from the rules of grammar, dictionaries and also previous judicial decisions.[68] While this ordinary meaning of words is the basis for the interpretation of contracts, the law does not require a strict literal approach, but allows a more liberal interpretation, for instance where the ordinary meaning would be obviously contrary to the genuine intention of the parties to the contract or in order to "avoid absurdity" or clarify an inconsistency or to give a contract a "commercially sensible meaning".[69] Most of the time, where

[60] See, eg, *Associated British Ports v Ferryways NV* 2009 1 Lloyd's Rep 595; *WS Tankship II BV v Kwangju Bank Ltd* 2011 EWHC 3103 (Comm).

[61] Furmston and Chuah (n 16) 382.

[62] Hapgood (n 15) 731.

[63] ibid.

[64] 2011 UKSC 50 (2011 1 WLR 2900 (SC)).

[65] Constable (ed) *Keating on Offshore Construction and Marine Engineering Contracts* (2015) 260–261, and 271–273; see also *Investors Compensation Scheme Ltd v West Bromwich Building Society* 1998 1 WLR 896 913; *Fairstate Ltd v General Enterprise & Management Ltd* 2010 EWHC 3072.

[66] Furmston and Chuah (n 16) 382.

[67] For a detailed discussion of how contracts are interpreted, see Christie and Bradfield *Christie's The Law of Contract in South Africa* (2011) 199–234.

[68] *Coopers and Lybrand v Bryant* (1995) 3 SA 761 (A); see also Van der Merwe, Van Huyssteen, Reinecke *et al Contract General Principles* (2012) 264 and the authorities cited in footnotes 356–360; Christie and Bradfield (n 67) 213–220.

[69] Van der Merwe *et al* (n 68) 264–265 and the authorities cited in footnotes 361–363.

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possible, effect must be given to every word in a contract and the words must be construed within the context of the contract as a whole, while bearing in mind the fact that a contract may comprise of more than one document and that the content of a document may be supplemented by incorporation of terms from another document.[70] This apparently means that the words must be interpreted in their full context, including all "background/surrounding circumstances" or "factual matrix".[71] Interpretation generally involves a four step technique.[72] First the ordinary grammatical meaning of words in the contract is considered; second, attention is given to the context in which the words or phrases are used, as measured against the contract as a whole; third, attention is given to the background circumstances to determine the purpose of the contract; and last, cognisance is taken of the surrounding circumstances where, for example, the language in the contract is ambiguous.[73] Nonetheless, the ordinary grammatical meaning will not easily be ignored and the belief is still that the ordinary meaning is *prima facie*, the most likely meaning intended by the parties to the contract.[74]

The South African Supreme Court of Appeal in *Mutual and Federal Insurance Company Limited v KNS Construction (Pty) Limited*[75] in deciding whether a performance guarantee constituted a suretyship or a primary/independent guarantee, approved and followed this contemporary interpretation method of "matrix of facts" or "background/surrounding circumstances". It used this modern-day interpretation method to conclude that it was the intention of the parties in this case to create an accessory obligation similar to a suretyship in their performance guarantee.[76]

The facts in the *Mutual and Federal* case, shortened for the purpose of this contribution, were as follows. The South African National Roads Agency Limited concluded a contract for the construction of road works in KwaZulu-Natal ("the main contract") with KNS Construction (Pty) Limited ("KNS Construction"). KNS Construction in turn appointed a sub-contractor, Aqua Transport & Plant Hire (Pty) Ltd, for the construction works. In terms of the sub-contract, the sub-contractor was required to provide a performance guarantee to the value of 15 per cent of the main contract. The guarantee was not to have an expiry date. Mutual and Federal Insurance Company Limited (guarantor), issued the guarantee on 5 April 2011 on behalf of the sub-contractor (applicant of the guarantee) for

[70] Van der Merwe *et al* (n 68) 265.

[71] Van der Merwe *et al* (n 68) 265; *KPMG Chartered Accountants (SA) v Securefin Ltd* 2009 4 SA 399 (SCA). In the *KPMG* case the Supreme Court of Appeal fittingly made the point that there was no merit in trying to distinguish between "background circumstances" and "surrounding circumstances" as such a distinction was artificial as both terms were in reality vague and confusing. It simply stated that the terms "context" or "factual matrix" would suffice.

[72] *Coopers* case (n 68); Christie and Bradfield (n 67) 213.

[73] ibid.

[74] Van der Merwe *et al* (n 68) 265–266.

[75] (208/2015) (2016) ZASCA 87 (31 May 2016).

[76] For cases where this modern method of interpretation was approved, see, eg, the *Zanbuild* case (n 51); *KPMG* case (n 71); *First National Bank – A Division of Firstrand Bank Limited v Clear Creek Trading 12 (Pty) Ltd* (1054/2013) (2015) ZASCA 6 (9 March 2015); *Novartis SA v Maphil Trading* 2016 1 SA 518 (SCA). In the *Novartis* case the Supreme Court of Appeal said (par 27):

> ". . . the interpretative process is one of ascertaining the intention of the parties – what they meant to achieve. And in doing that, the court must consider all the circumstances surrounding the contract to determine what their intention was in concluding it. . . and the court should always consider the factual matrix in which the contract is concluded – the text to determine the parties' intention."

the due fulfilment of the sub-contractor's obligation to KNS Construction (ie, beneficiary of the guarantee) pursuant to the sub-contract entered into between the sub-contractor and KNS Construction.[77]

Clauses 1 to 3 of the performance guarantee issued by the guarantor (Mutual and Federal) provided as follow:[78]

> "1 . . . Mutual & Federal Insurance Company Limited . . . (hereinafter referred to as "the Guarantor") do hereby hold at your disposal the amount of R3 423 850.49 . . . for the due fulfilment by Aqua Transport & Plant Hire (Pty) Ltd . . . (hereinafter referred to as "the sub-contractor") of its obligations to KNS Construction (Pty) Ltd . . . thereafter referred to as "KNS" in terms of the above stated contract between the Sub-Contractor and KNS.
>
> 2. The Guarantor hereby renounces the benefits of the exceptions *non numeratae pecuniae, non-causa debiti,* excussion and division, the meaning and effect whereof we declare ourselves to be fully conversant.
>
> 3. The Guarantor undertakes to pay KNS the said amount of R3 423 850.49 . . . or such portion as may be demanded on receipt of a written demand from KNS which demand may be made by KNS if, (in your opinion and at your sole discretion), the said Contractor fails and/or neglects to commence the work as prescribed in the contract or if he fails and/or neglects to proceed therewith or if, for any reason, he fails and/or neglects to complete the services in accordance with the conditions of contract, or if he fails or neglects to refund to KNS any amount found to be due and payable to KNS, or if his estate is sequestrated or if he surrenders his estate in terms of the Insolvency Law in force within the Republic of South Africa."

Shortly after the main and sub-contracts were concluded and the guarantee was issued KNS Construction started to experience financial problems which caused it to not being able to perform in terms of the main contract. This in turn also caused the sub-contractor not being able to perform its obligations in terms of the sub-contract. KNS Construction was also not able to pay the sub-contractor for work it had already performed. Eventually KNS Construction placed itself under voluntary winding-up in terms of a special resolution registered by the Master of the High Court on 13 December 2011. The next day the site was closed resulting in no work being carried out. This resulted in the South African National Roads Agency Limited cancelling the main contract. [79]

During January 2012 KNS Construction was also placed under provisional winding-up at the instance of one of its creditors. The provisional order was made final and provisional liquidators were appointed. The appointment was made final on 11 July 2012. Prior to these two winding-up applications, one of KNS Constuction's creditors had already instituted a winding-up application in 2010 in the North Gauteng High Court, Pretoria, which application was dismissed. The creditors in that application were unhappy with the dismissal and lodged an appeal to the full bench. On 19 September 2012, a full bench upheld the appeal and KNS Construction was accordingly placed in final winding-up retrospectively to 8 October 2010.[80]

Notwithstanding these insurmountable difficulties, and the fact that the site was abandoned with no work being carried on in terms of the main contract, KNS Construction, on 14 December 2011, a mere day after it had placed itself under voluntary winding up, notified the sub-contract, that it intended to cancel their

[77] *Mutual and Federal* case (n 75) par 1.
[78] par 2.
[79] par 3.
[80] par 4.

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contract. KNS Construction gave the sub-contractor 14 days' notice to rectify its performance and warned that failing to do so would result in KNS Construction making a demand for payment in terms of the performance guarantee issued in its favour. The threat to make a demand in terms of the guarantee was later followed up by the liquidators on two different occasions. The ground for the calling up the guarantee was the failure by the sub-contractor to commence, proceed with or complete the construction contract.[81]

The sub-contractor instituted an application in the South Gauteng High Court, Johannesburg on 28 May 2012 to interdict the guarantor (Mutual & Federal) from making the payment in terms of the guarantee. By agreement between the parties, the guarantor was interdicted from honouring the guarantee pending resolution of proceedings to be instituted within 30 days by KNS Construction. Eventually, KNS Construction instituted an application in the Gauteng Local Division of the High Court, Johannesburg ("court *a quo*") demanding payment from the guarantor based on the guarantee. KNS Construction claimed payment on the ground that the guarantee was an independent/primary guarantee and therefore was payable. The sub-contractor disagreed and contended that the guarantee was in reality an accessory (traditional) guarantee akin to a suretyship. The sub-contractor also argued that it was not in breach of the sub-contract and, therefore, the guarantee was not due and payable.[82]

The court *a quo* (*per* Twala AJ) concluded that the guarantee was an independent (primary) guarantee and therefore the guarantor was obliged to pay if a demand made in terms thereof complied with the terms of guarantee. The guarantor and the sub-contractor appealed and the matter was heard by the Supreme Court of Appeal.[83]

The main question the Supreme Court of Appeal had to answer was whether the guarantee in the case constituted an accessory guarantee or was a primary guarantee. In deciding what the actual nature of the guarantee was, the Supreme Court of Appeal followed the modern interpretation method of "matrix of facts" or "background/surrounding circumstances" it had set out in its earlier judgment in *Novartis SA v Maphil Trading*.[84] In the process the court also referred to some of its previous decisions in this regard.[85] It specifically referred to its earlier judgment in the *Zanbuild* case[86] where it had held that the guarantee there gave rise to a liability akin to that of a surety:[87]

> "The first indicator in that direction is the assertion at the outset that the guarantee provide 'security for the compliance of the contractor's performance of obligations in accordance with the contract'. And in the body of the document the bank guarantees "the due and faithful performance by the contractor". This accords with language associated with suretyships."

The Supreme Court of Appeal in the *Mutual and Federal* case found that "the language used in the guarantee and its purpose reveal the true intention of the parties".[88] It held that the language used, particularly in clause 1 and 3 of the

[81] par 5.
[82] par 6.
[83] par 7.
[84] 2016 1 SA 518 (SCA). See also the *Mutual and Federal* case (n 75) par 8 and 9.
[85] See, eg, *Lombard* case (n 36) par 19, 20; *Zanbuild* case (n 51).
[86] *Zanbuild* case (n 51).
[87] *Zanbuild* case (n 51) par 19.
[88] *Mutual and Federal* case (n 75) par 13.

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guarantee, which has been quoted above, was similar to that in the *Zanbuild* case.[89] It stressed that even though the guarantee in the case provided that it was payable at the discretion of KNS Construction, and that payment in terms of it could be demanded "at any stage", the real purpose was to guarantee the due performance by the sub-contractor.[90] It was clear to the court that the guarantee was only payable if the sub-contractor breached his contract with KNS Construction (ie, the sub-contract) as explicitly stated in the guarantee.[91] Hence it held that although the demand was at the discretion of KNS Construction, that aspect did not affect the nature of the guarantee. The discretion vested in KNS Construction was to be exercised "*arbitrio bono viri*". The trigger event for payment was when the sub-contractor failed to commence, proceed with or complete the sub-contract.[92]

The Supreme Court of Appeal also added that the fact that the guarantee was not accompanied by any document before payment was demanded, but depended on breach of the sub-contract by the sub-contractor in either failing to commence, proceed with or complete the project, gave credence to the fact that the guarantee was inextricably linked to the sub-contract and therefore similar to a suretyship. The inevitable conclusion was therefore that the guarantee was similar to a suretyship (like that in *Zanbuild*) and not a demand guarantee.[93] Therefore, the court *a quo* was wrong in finding that the guarantee constituted a primary obligation. The appeal by the guarantor and the sub-contactor was therefore upheld.[94]

The Supreme Court of Appeal's judgment in *Mutual and Federal* cannot be faulted. It is evident that the language used in the guarantee constituted an accessory liability, despite the use of the term "performance guarantee". If one were to look solely at the title of this instrument, without also considering the actual language used, one could easily have assumed wrongly that a primary liability was created. Although the court relied on the wording and language used in clauses 1 and 3 of the guarantee, it could also have relied on clause 2 of the guarantee (quoted above) which excluded or limited the defences available to the *Mutual and Federal*, to further strengthen its view that the guarantee was accessory rather than primary.[95]

### 3 *Statement of breach*

Often demand guarantees are payable on first demand without any additional documents. The beneficiary of such a guarantee is simply required to make a demand for payment in the form stipulated in the guarantee. But, there are also many demand guarantees requiring the beneficiary to present at least a written statement indicating that the principal/applicant is in breach/default.[96] Determining whether or not the demand guarantee, requires the beneficiary to assert a breach of contract by the principal/applicant is a matter of properly construing the demand guarantee.[97]

[89] par 13.
[90] par 14.
[91] par 14.
[92] par 15.
[93] par 15.
[94] par 16–18.
[95] Hapgood (n 15) 731.
[96] Hapgood (n 15) 730.
[97] ibid.

Where the demand guarantee is subject to international practice rules, for instance the URDG 758, it is easy to determine whether an assertion of breach is required.[98] This is so, because art 15*(a)* of the URDG 758 provides that:[99]

> "A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand."

If a demand guarantee calls for any other documents (eg, a document issued by a third party such as an architect, engineer or arbiter, or a court order) to be presented together with the demand, it will usually be clearly stipulated in the guarantee itself. It will generally be straightforward to determine from the wording of the demand guarantee whether or not such other documents have to be presented.[100]

However, it is much more difficult to determine whether a demand guarantee which is not subject to the URDG 758 (or its processor, URDG 458) requires, on its true construction, a statement from the beneficiary asserting the breach of the principal/applicant.[101]

### 4 *Doctrine of Strict Compliance*

It is also a question of construing the demand guarantee when it is necessary to determine whether the documents presented by the beneficiary comply with the terms and conditions of the guarantee. It is inevitable that when such a determination is to be made that it will give rise to the issue of what the required degree of strictness of compliance is for the documents that must be presented.[102] Determining whether or not a compliant demand was made, entails, firstly, a proper interpretation of the terms of the demand guarantee and, secondly, a comparison of these terms against the actual demand and/or other documents that were presented.

As mentioned earlier, letters of credit and demand guarantees are documentary in nature. The issuers and guarantors deal with documents only and have no obligation to authenticate the documents submitted. In order for issuers and guarantors to decide if a compliant demand has been made they need to only consider the documents specifically called for in the letter of credit or guarantee. Documents not particularly mentioned in the credit or guarantee may be disregarded even if they have been presented and have been found to be inconsistent with the documents required.[103] The guarantor's duty relating to a demand guarantee is simply to pay against specified documents that are presented within the period and in accordance with the other conditions of the construction guarantee.

The significance of documents in relation to documentary credits and demand guarantees means that, other than the documents, the guarantors have no means

[98] Hapgood (n 15) 732.
[99] See also art 2(*a*) read with art 20(a) of the URDG 458 (ie, the predecessor of URDG 758).
[100] Hapgood (n 15) 732.
[101] Hapgood (n 15) 732. For examples illustrating the difficulty in doing so, see *IE Contractors Ltd v Lloyds Bank plc and Rafidain Bank* 1990 2 Lloyd's Rep 496 (CA) 501; *Esal* case (n 59); *Banque du Caire SAE v Wells Fargo Bank NA* 1985 2 Lloyd's Rep 546 (CA).
[102] Hapgood (n 15) 730.
[103] Furmston and Chuah (n 16) 380.

of ensuring that the beneficiary is entitled to payment.[104] Therefore, they insist that the documentary conditions are strictly performed by the beneficiary.[105] The rule is thus that the documents presented must "strictly comply" with those that have been called for documentary credit[106] and "there is no room for documents which are almost the same, or which will do just as well".[107] The doctrine of strict compliance was developed for commercial letters of credit.[108]

Under English law it is settled that the doctrine of strict compliance applies with regard to commercial letters of credit.[109] It is not completely settled in South Africa as to what the required standard of compliance is regarding documents that are presented in terms of commercial letters of credit, but case law suggests that South Africa follows the English law in this regard and also applies the principle of strict compliance to commercial letters of credit.[110]

Whether or not strict compliance is also required for demand guarantees under the English law is less clear.[111] In some of the old English cases[112] the courts have expressed their opinion that the doctrine of strict compliance did not apply with the same strictness to demand guarantees. For instance, in *Siporex Trade SA v Banque Indosuez*[113] the English High Court held that the doctrine of strict compliance was not to be applied to demand guarantees. The main reason was that, in letters of credit, guarantors (eg, banks) are dealing with the documents, therefore strict compliance is vital. In contrast, in demand guarantees, the guarantors (banks) are dealing with no more than a statement in the form of a declaration to the effect that a certain event or default has occurred.[114] In more recent English cases,[115] however, the courts have taken the view that the principle of strict compliance

[104] ibid.
[105] ibid.
[106] ibid.
[107] *Equitable Trust Company of New York v Dawson Partners Ltd* (1927) 27 Lloyd's Rep 49 (HL) 52.
[108] Hugo "Construction guarantees and the Supreme Court of Appeal (2010–2013)" in Visser and Pretorius (eds) *Essays in Honour of Frans Malan: Former Judge of the Supreme Court of Appeal* (2014) 159 163. For a discussion of the development and application of this doctrine, see Chuah (n 42) 600–604 and the authority cited there; Malek and Quest (n 32) 184–189 and the authorities cited there; King *Gutteridge & Megrah's Law of Bankers' Commercial Credits* (2001)181–187; Adodo (n 35) 151–160; M Kelly-Louw (n 40 (2016)) 92–96.
[109] See, eg, *English, Scottish and Australian Bank Ltd v Bank of South Africa* (1922) 13 Lloyd's Rep 21 24; *Equitable Trust* case (n 107) 52; *JH Rayner and Company Ltd v Hambro's Bank Ltd* 1943 KB 37 (CA) 40–41; *Bank Melli Iran v Barclays Bank (Dominion, Colonial and Overseas)* 1951 2 Lloyd's Rep 367 (KB) 374–375; *Moralice (London) Ltd v ED&F Man* 1954 2 Lloyd's Rep 526 (QB) 532; *Gian Singh & Co Ltd v Banque de L'Indochine* 1974 2 Lloyd's Rep 1 12; *Banque de L'Indochine et de Suez SA v JH Rayner (Mincing Lane) Ltd* 1983 1 QB 711 (CA) (1983 1 Lloyd's Rep 228 (CA)) 730; *Glencore International AG v Bank of China* 1996 1 Lloyd's Rep 135 146.
[110] See, eg, *Delfs v Kuehne and Nagel (Pty) Ltd* 1990 1 SA 822 (A); *Nedcor Bank Ltd v Hartzer* 1993 CLD 278 (W); *Loomcraft* case (n 35) 815; *Standard Bank of South Africa Ltd v OK Bazaars (1929) Ltd* 2000 4 SA 382 (W); *OK Bazaars* case (n 41) 697G–698A; *Stefanutti & Bressan (Pty) Ltd v Nedbank Ltd* 2008 JDR 0914 (D); *Casey v First National Bank Ltd* 2013 4 SA 370 (GSJ) par 24 and 26; *Lombard* case (n 36).
[111] Furmston and Chuah (n 16) 382. For a detailed discussion, see Chuah (n 42) 626–629; Enonchong *The Independence Principle of Letters of Credit and Demand Guarantees* (2011) 82–93; Kelly-Louw (n 40 (2016) 96–108.
[112] See, eg, the *Siporex* case (n 59) and *IE Contractors* case (n 101).
[113] *Siporex* case (n 59).
[114] See the *Siporex* case (n 59) 159. The English Court of Appeal in the *IE Contractors* case (n 101) 501 had also approved this statement. See also Furmston and Chuah (n 16) 382.
[115] See, eg, *Frans Maas (UK) Ltd v Habib Bank AG Zurich* 2001 Lloyd's Rep Bank 14.

applies to demand guarantees, like it does to letters of credit.[116] Although the issue is still unsettled, recent English court cases create the impression that there is not distinction between the standard of compliance required for commercial letters of credit and demand guarantees.[117]

There is also doubt under the South African law as to whether or not the principle of strict compliance applies to demand guarantees.[118] Although there is no case law that explicitly holds that the principle is, in fact, applicable to demand guarantees, there are instances where the courts have indicated or said that it does. For instance, the court in *Stefanutti & Bressan (Pty) Ltd v Nedbank Ltd*[119] accepted that the principle of strict compliance applies to demand guarantees.[120] In *Grinaker-LTA Rail Link Joint Venture v Absa Insurance Company Limited*[121] the court even went so far as to say that the South African cases[122] apply the principle of strict compliance to demand guarantees.[123] There are also indications in other cases, including Supreme Court of Appeal cases, which show that the South African courts in reality support the notion that the doctrine of strict compliance also applies to demand guarantees.[124] But, there are also a few cases implying that a strict compliance with the terms of a construction (demand) guarantee is not required, and that a less strict standard of compliance applies.[125]

In the last couple of years, the South African courts were confronted, on a number of occasions, with the argument that the standard of compliance that applied to demands and documents submitted in terms of demand guarantees was less strict than the standard that applied to commercial letters of credit.[126] In these cases, reliance was placed on the English cases supporting such an argument.

The key question before the Supreme Court of Appeal in *Compass Insurance Co Ltd v Hospitality Hotel Developments (Pty) Ltd*[127] was whether or not a the

[116] Furmston and Chuah (n 16) 382. For a discussion of this newer approach by English Courts, see Kelly-Louw (n 40 (2016)) 83, 91; Chuah (n 42) 626.

[117] See, eg, *Ermis Skai Radio and Television v Banque Indosuez Europa SRL* (unreported, 26 February 1997) *Maridive & Oil Services (SAE) v CAN Insurance Co (Europe) Ltd* 2002 EWCA Civ 369; *Lorne Stewart plc v Hermes Kreditversicherungs AG and Amey Asset Services Ltd* 2001 All ER (D) 286; *Consolidated Oil Ltd v American Express Bank* (2002) CLC 488 (CA); *Sea-Cargo Skips AS v State Bank of India* 2013 1 Lloyds Rep 477 (QB (Com Ct)). For more examples, see also all the authorities in this regard listed in Enonchong (n 111) 87–88; Chuah (n 42) 627–628. For more on this, see also Malek and Quest (n 32) 369.

[118] Kelly-Louw (n 40 (2016)) 113–129; 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* 661 662.

[119] *Stefanutti* case (n 110).

[120] *Stefanutti* case (n 110) par 16–18.

[121] (24110/2014) (2015) ZAGPJHC 302 (10 November 2015).

[122] For instance, *OK Bazaars* (n 41); *Lombard* (n 36); *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* 2014 1 All SA 307 (SCA).

[123] *Grinaker-LTA* case (n 121) par 14–17.

[124] This is evident from, for example, the judgments delivered in *Compass* (n 36); *Denel* (n 41); *State Bank of India v Denel SOC Limited* 2015 2 All SA 152 (SCA); *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng* 2015 5 SA 26 (GJ). See also Kelly-Louw (n 40 (2016)) 125–129; Hugo (n 108 (2014)) 163.

[125] See, eg, *GLMB Joint Venture v Constatia Insurance Co Ltd* (2012/17774) (2014) ZAGPJHC 440 (17 January 2014); *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* (23125/2014) (2015) ZAGPJHC 264 (20 October 2015); *University of the Western Cape v Absa Insurance Company Ltd* (100/2015) (2015) ZAGPJHC 303 (28 October 2015).

[126] See, eg, *Compass* (n 36); *Denel* (n 41); *State Bank of India* (n 124); *Kristabel* (n 125); *University of the Western Cape* (n 125).

[127] (n 36); for a discussion of this case, see Kelly-Louw (n 40 (2016)) 113–116.

beneficiary had made a compliant demand. The demand guarantee provided that either a copy of the liquidation order or a copy of the letter of cancellation (whichever one was applicable in the situation) had to be attached to the demand for payment. The beneficiary made a demand as required, but failed to attach a copy of the liquidation order as was called for by the demand guarantee. The beneficiary only submitted a copy of the liquidation order to the guarantor months later and after the guarantee had already expired. This caused the guarantor to refuse to the pay under the guarantee. The beneficiary, relying on the English authorities, argued that the doctrine of strict compliance was limited to commercial letters of credit,[128] and, therefore, the guarantor was obliged to pay in terms of the demand guarantee. The Supreme Court of Appeal found that the requirements to be met in making the demand were "absolutely clear", and there "was in fact no compliance, let alone strict compliance". The court stressed that the guarantee had made it crystal clear that a copy of the liquidation order had to be attached to the demand and it was not.[129] However, based on the merits of the case the Supreme Court of Appeal concluded that it was not necessary to decide whether "strict compliance" was applicable to demand guarantees and therefore it did not deal with this issue.

The court a *quo* in *Denel Soc Limited v ABSA Bank Limited*[130] also entertained a similar allegation, namely that a less strict standard of compliance applied to demand guarantees, but did not express any opinion on the matter. The Supreme Court of Appeal in *State Bank of India v Denel SOC Limited*[131] in hearing the appeal against the judgment of the court a *quo*, also unfortunately did not give its view as to whether or not the principle of strict compliance was applicable to demand guarantees.[132]

*Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited*[133] and *University of the Western Cape v Absa Insurance Company Ltd*[134] are the latest two cases where the argument that a less strict standard of compliance applies to demand guarantees was raised. These two cases seemingly imply that strict compliance with the terms of a construction (demand) guarantee is not required, and that a less strict standard of compliance applies to a demand guarantee.

### 4.1 Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited

In *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited*[135] the guarantor had issued a construction (demand) guarantee for a maximum amount of R20 731 119.36 on 31 October 2012 in favour of the beneficiary (Credit Guarantee Insurance Corporation of Africa Limited), which was the employer of the construction contract (a South African Joint Building Contracts Committee ("JBCC") contract (ie, the underlying contract)). The construction guarantee provided the following in clause 5 of it:

[128] *Compass* (n 36) par 7–9, 11.
[129] *Compass* (n 36) par 13.
[130] *Denel* (n 41) (hereinafter "the court a quo").
[131] *State Bank of India* (n 124).
[132] For more on this issue and a discussion of the decision of the court *a quo* and that of the Supreme Court of Appeal, see Kelly-Louw (n 40 (2016)) 116–129.
[133] *Kristabel* (n 125).
[134] *University of the Western Cape* (n 125).
[135] *Kristabel* (n 125).

"Subject to the Guarantor's maximum liability referred to in 1.0 or 2.0, the Guarantor undertakes to pay the Employer the Guaranteed Sum or the full outstanding balance upon receipt of a first written demand from the Employer to the Guarantor at the Guarantors physical address calling up this Construction Guarantee. . . ."

Clause 5 of the construction guarantee further required that the first written demand had to state that:

"5.1 The Agreement has been cancelled due to the Contractor's default and that the Construction Guarantee is called up in terms of 5.0. *The demand shall enclose a copy of the notice of cancellation*; or

5.2 A provisional sequestration or liquidation court order had been granted against the Contractor and that the Construction Guarantee is called up in terms of 5.0. The demand shall enclose a copy of the court order." [Emphasis added.]

The underlying construction contract was cancelled on 30 April 2014 by the beneficiary on ground of an alleged breach by the contractor third party (the applicant/principal of the construction guarantee). The beneficiary had not only sent the letter of cancellation of the underlying (construction) contract to the contractor third party, but also e-mailed a copy of it to the guarantor on 20 May 2014. The guarantor acknowledged that it had received the copy of the letter of cancellation. On 4 June 2014, the beneficiary formally demanded payment of R12 438 671.61 in terms of the construction guarantee from the guarantor. The beneficiary's letter of demand sent to the guarantor read as follows:[136]

"(3) On 30 April 2014, and as a result of the contractor's default and repudiation of its obligations arising in terms of the Agreement, we cancelled the Agreement.

(4) We enclose under cover of this letter, marked as annexure "A", a copy of our letter of cancellation.

(5) Pursuant to clauses 5.0 and 5.1 of the guarantee, we demand payment from you of the amount of the guaranteed sum, R12 438 671.61.

(6) Pursuant to clause 8 of the guarantee, we accordingly await payment by you of this amount within 7 days of the date of this letter". [Emphasis added.]

The beneficiary failed to attach a copy of the letter of cancellation to the letter of demand dated 4 June 2014.[137] The beneficiary had, however, on 20 May 2014, just a few days before the formal demand was made, sent a copy of the letter of cancellation to the guarantor. The guarantor's attorneys were also copied on e-mails on meetings subsequent thereto during May 2014.[138] It thus appeared that the guarantor was, in fact, aware of the letter of cancellation and had in its possession a copy of said letter of cancellation.

The beneficiary then launched motion court proceedings against the guarantor claiming payment of R12 438 671.61 in terms of the construction guarantee. Prior to the matter being heard by the court various dealings (meetings and a series of e-mails) took place between the parties by means of their respective attorneys in what appeared to be an effort to resolve the matter. There was a disagreement between the parties to the construction guarantee's respective quantity surveyors regarding certain aspects of the underlying construction contract (eg, certain measurements). The parties also requested reports by their respective quantity surveyors. There was also some type of dispute concerning the cancellation of the underlying contract.

[136] *Kristabel* (n 125) par 21.
[137] par 23.
[138] par 22.

In the communications sent by the attorneys of the beneficiary it was alleged that "all of the information forwarded to you by our client was obviously done so as part of the without prejudice engagement taking place between our clients".[139] In some of the e-mails by the beneficiary the guarantor was requested to indicate what its "overall settlement proposal" was and what the exact amount was that it would pay. On 4 November 2014 the guarantor paid R6 060 404.22 into the trust account of the beneficiary's attorney. The beneficiary's attorney acknowledged receipt of the payment on 11 November 2014 and clearly stressed that the payment was accepted "without prejudice of its rights regarding the claim for payment of the balance of the guaranteed amount".[140] The beneficiary's attorney subsequently requested a complete breakdown from the guarantor which showed how this amount had been arrived at and the guarantor's reasons for not paying the outstanding amount which was accordingly still owed in terms of the construction guarantee.[141]

It seemed that one of the terms the parties had agreed to during their dealings with each other was that each party's quantity surveyor would, after the payment was made into the attorney's trust account, assess the further costs incurred since the construction guarantee was called up, together with any additional costs to be incurred, whereafter the attorney would pay the beneficiary out of the funds held in trust, on receipt of an instruction to that effect.

Later the beneficiary indicated in an e-mail that it was no longer willing to postpone the matter and that it would institute an application to claim the balance of the guaranteed amount, namely R 6 378 266.39, and that it would withdraw the initial motion court proceedings. The attorneys of the guarantor responded to this e-mail and indicated that there were still a few unsettled issues and stressed that the payment that the guarantor made was not made in full and final settlement of any particular heads or claim/components and that clause 7 of the construction guarantee remained applicable to the amounts claimed. Later that day, the attorneys of the guarantor confirmed in a second e-mail that the earlier e-mail was sent in a "without prejudice context, and without admission of liability, as also entirely [without] prejudice to all our client's rights including its right in terms of clause 7 of the guarantee". Clause 7 of the construction guarantee provides for the deduction of any prior part payments from the guaranteed payment and for calculation of final amounts owing.[142]

The beneficiary then proceeded with action in the Gauteng Local Division, Johannesburg, against the guarantor for non-payment of the balance owned in terms of the construction guarantee.

The guarantor opposed the application on two grounds. Firstly, it claimed that the subsequent agreement of settlement novated the earlier construction guarantee. The beneficiary denied that there was an agreement reached between it and the guarantor which novated the original construction guarantee. In the beneficiary's view there was, "at most, certain proposals to resolve the dispute and an on-going attempt to resolve the matter which foundered upon the mechanisms of resolution".[143] Satchwell J, who heard the matter, agreed. She was not convinced that there was an agreement reached between the parties which novated the earlier

[139] par 2(n).
[140] par 17.
[141] par 2 and 15.
[142] par 2.
[143] par 3.

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construction guarantee.[144] Satchwell J, found that the terms or basis upon which the parties had met and agreed to resolve the matter were "uncertain, incomplete and apparently incapable of being finalised".[145] According to Satchwell J, the agreement between the parties amounted to nothing more than a provisional attempt to resolve the dispute, which was already the subject-matter of litigation, namely the payment of around R12 million in terms of the construction guarantee. As a result, the issued construction guarantee remained operative and was not novated.[146]

The second ground upon which the guarantor opposed the beneficiary's claim for payment was that there was non-compliance with the terms of the guarantee. The guarantor contended that because the beneficiary had failed to attach a copy of the letter of cancellation to the formal demand, there was no strict compliance with the terms of the construction guarantee. The failure to comply with a peremptory provision of the guarantee, therefore, made the beneficiary's demand fatally defective. The beneficiary disagreed and argued that "strict" compliance was not a requirement, that a copy of the letter of cancellation had been delivered prior to the official demand for payment which constituted compliance and that, in any case, the guarantor had waived any entitlement to require the beneficiary to attach a copy of the letter of cancellation to the demand.[147]

Satchwell J said that before she could deal with this second ground raised by the guarantor she first had to decide whether or not "prior" compliance rather than "contemporaneous" compliance in the context of this specific case meant that there had not been the required compliance with the construction guarantee.[148] She had to decide whether or not the submission of the copy of the letter of cancellation to both the guarantor and its attorneys independently of and prior to the demand being made constituted compliance with the construction guarantee.

She examined some of the South African[149] and English case law[150] dealing with the issue of strict compliance.[151] She pointed out that the English law seemingly drew a distinction between the standard of compliance required for letters of credit and for construction (demand) guarantees and said:[152]

> "Accordingly, the English courts (followed by the South African courts) have, thus far, taken the approach that there is a difference or 'contrast' between a guarantee where the call is simply based on the say-so statement of the one party that an event has occurred and between letters of credit where the bank is in possession of documents (such as bills of lading) establishing the foundation of the call. The courts have indicated that the more 'strict' compliance is required of the banks and of the documents presented to activate letters of credit because the banks themselves are in a position to evaluate the call by perusing the various documents. No mention has been made of the degree of rigour of compliance in the case of performance guarantees."

Satchwell J aptly confirmed that the South African courts have not yet found it necessary to determine whether or not "strict" compliance was required of the beneficiary under a performance (construction) guarantee. She referred to the

[144] par 5 and 48.
[145] par 6.
[146] par 50 and 51.
[147] par 24.
[148] par 25.
[149] See, eg, *Lombard* (n 36); *Loomcraft* (n 35); *OK Bazaars* (n 41) par 25.
[150] See, eg, *Siporex* (n 59); *IE Contractors* (n 101).
[151] *Kristabel* (n 125) par 26–33.
[152] par 30.

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*Compass* case[153] where the South African Supreme Court of Appeal had left open the issue of whether or not "strict" compliance applied.[154] Satchwell J felt that the case before her was distinguishable from the *Compass* case, because in *Compass* there "was only a belief or 'knowledge' that the required condition for breach, i.e. liquidation, had taken place – no one was in possession of the requisite order which was expressly required to be attached to the demand".[155] However, in the case before her, the notice of cancellation did exist and was sent to the guarantor and received by the guarantor. Furthermore, the guarantor's attorneys were copied in on the correspondence arranging meetings to discuss this cancellation in May 2014. Therefore, the existence of the cancellation of the underlying contract and the reasons for the cancellation were known to the guarantor at the time the formal demand was made.[156] Satchwell J also said:[157]

> "[t]o require that this notice of cancellation, already received and discussed and engaged upon, be attached to the notice of demand 15 days later is not requiring moonwalking and beneficiary/applicant could certainly have complied therewith. However, to find that failure to attach a written cancellation already received and under discussion, constitutes complete non-compliance with the terms of the guarantee and therefor disentitles the beneficiary/applicant from proceeding with its demand under that guarantee is, I believe, a step too far. The reasons requiring compliance with terms of the guarantee, especially as restated by the Supreme Court of Appeal in Compass *supra*, are carefully kept in mind in the present instance."

The judge held that the prior presentation of a copy of the cancellation letter by the beneficiary to the guarantor (and its attorneys) instead of simultaneous presentation with the demand, based on the facts of this case, did constitute compliance with the guarantee.[158]

Satchwell J shared the beneficiary's view that the guarantor had waived any right to void the letter of demand. She found, based on the facts of the case, that the guarantor had indeed waived its right of insisting on compliance with the terms of clause 5 of the demand guarantee.[159] She pointed out that the guarantor could merely have said no to the payment, but instead it elected to pay, thereby waiving its right to challenge the compliance of the demand. [160]

The court ordered the guarantor to pay to the beneficiary the amount of R6 378 266, 39 plus interest at the legal rate of interest. It further ordered the guarantor to pay the costs of the application including the costs of the unopposed motion of 23 February 2015 when costs were reserved.

Satchwell J's finding that the construction guarantee was not novated by a subsequent agreement between the parties is correct.

However, whether or not she is correct in her view that there has, in fact, been compliance in the *Kristabel* case, is debatable. In my view, she erred in finding that the facts in the *Compass* case were distinguishable from the facts in *Kristabel*. Under various English authorities, as well as South African authorities, it has clearly been acknowledged (or at least implied) that it is not really a matter of whether strict

[153] *Compass* case (n 36).
[154] *Kristabel* (n 125) par 31.
[155] *Kristabel* (n 125) par 32.
[156] par 34.
[157] par 38.
[158] par 39.
[159] par 47.
[160] par 52.

compliance applies or not to a demand guarantee, but rather whether there has been actual compliance and whether what was called for in the guarantee was truly submitted or not. This notion is also confirmed by the judgment given in the *Compass* case. The fact that what was called for in *Compass*, namely a copy of liquidation order, was only submitted long after the demand was made, and what was called for in *Kristabel*, namely a copy of cancellation letter, was already submitted to the guarantor before the demand was made, is beside the point. In both these cases, the beneficiaries of the guarantees had neglected to attach what was asked for in the guarantee simultaneously with the demand. Thus, in both instances, there were non-compliant demands made and in both there was no compliance let alone strict compliance.

Furthermore, Satchwell J's view in *Kristabel* seems to be in conflict with her earlier view expressed in *Group Five Construction (Pty) Limited v Member of the Executive Council for Public Transport Roads and Works Gauteng*,[161] a similar case. In the *Group Five Construction* case Satchwell J was also asked to decide whether a compliant demand was made in terms of a construction guarantee. The construction guarantee in this case provided that the demand for payment had to state that the guarantee was called up because the underlying contract had been cancelled and the demand had to be accompanied by a notice of cancellation of the underlying contract. The guarantee, similar to the one in *Kristabel*, also required that the demand had to enclose a copy of the notice of cancellation of the underlying contract. As with the *Kristabel* case, the beneficiary in the *Group Five* case also failed to attach a copy of the cancellation notice to its demand. The beneficiary in latter case then tried to rectify its default after the demand was made.[162] Satchwell J, however, relying on the *Compass* case, as authority, questioned whether, because no notice of cancellation was submitted at the time the demand for payment was made, the demand could be regarded as compliant, valid and enforceable.

Satchwell J is, however, correct when she states in *Kristabel* that the application of strict compliance to demand guarantees has not been settled in South Africa.

It is questioned whether the court in *Kristabel* was correct in its finding that the guarantor had waived its right to insist on compliance with the terms of clause 5 of the demand guarantee. In my view, it was evident during the dealings between the parties the payment the guarantor had made was "without prejudice and without admission of liability". Based the facts before the court as evidenced by the judgment there was nothing, in my view, to suggest that the guarantor had waived its rights to insist on compliance.

### 4.2 University of the Western Cape v ABSA Insurance Company Ltd

In *University of the Western Cape v ABSA Insurance Company Ltd*[163] CF Projects Cape (Pty) (contractor/applicant), in order to assure performance of a construction contract, obtained a construction guarantee (demand guarantee) issued in favour of the University of the Western Cape (beneficiary) by ABSA Insurance Company Ltd (guarantor) for the amount of R20 880 442.85. The amount of the construction

[161] *Group Five (*n 124).

[162] Satchwell J in *Group Five* (n 124) par 28 said:

> "I have my doubts whether or not a demand composed of dribs and drabs, ebbing and flowing like the tides could possibly meet the requirements for compliance. After all, when would either the employer or the guarantor be permitted to conclude that the demand was now complete and compliant. However, I need not decide that point"

[163] *University of the Western Cape* (n 125).

guarantee was later reduced to R13 128 265.71. The contraction guarantee was issued subject to South African law. Clause 5 of the construction guarantee stated that:

> "Subject to the Guarantor's maximum liability . . . the Guarantor undertakes to pay the Employer the Guaranteed Sum . . . upon receipt of a first written demand *from the Employer to the Guarantor* at the Guarantor's physical address calling up this Construction Guarantee stating that:
>
> 5.1 The Agreement has been cancelled due to the contractor's default and that the Construction Guarantee is called up in terms of 5.0. The demand shall enclose a copy of the notice of cancellation . . ." (Emphasis added.)

Clause 8 of the guarantee provided that the payment had to be made within seven calendar days after receipt of the first written demand. A note on the last page of the guarantee further provided:

> "In the event of a call on this Guarantee, Payment will only be made against return of this original Guarantee by the Employer *or the Employer's duly authorised agent*." (Emphasis added.)

When the contractor (applicant of the construction guarantee) failed to perform in terms of the underlying contract (construction contract), the beneficiary cancelled the contract on 30 May 2014. After the cancellation, the beneficiary made a demand on the construction guarantee.

The demand was, however, not made by the employer (and beneficiary), the University of the Western Cape, itself but by its agent, LMC Project Management (principal agent), on its behalf. The demand was also made on the principal agent's letterhead, and not on the beneficiary's (employer's) letterhead. The last paragraph of the demand letter read as follows:

> "University/Beneficiary of the Western Cape (Employer) herewith notifies the Guarantor that the Principal Building Agreement with . . . has been terminated due to the Contractor's default and the Construction Guarantee is called up in terms of Clause 5.1 of the Guarantee."

The demand was accompanied by a copy of the letter of cancellation of the underlying construction contract. When the guarantor refused to pay the construction guarantee, the beneficiary sued the guarantor in the High Court of South Africa, Gauteng Local Division, Johannesburg. The matter was heard by Fourie J.

The guarantor resisted payment in terms of the construction guarantee on two grounds: (1) the beneficiary had failed to comply with the terms of the guarantee; and (2) the beneficiary's conduct in making the demand was tainted by "impropriety".[164]

The guarantor argued that strict compliance, as in the case of letters of credit, was also applicable to construction (demand) guarantees. It insisted that the demand that was made did not constitute strict compliance with the terms of the construction guarantee because the demand was not made by the beneficiary, but by its principal agent. Fourie J stated it was clear from the letter of demand, in particular the last paragraph, as quoted above, that the agent was acting not in its own name, but as the representative of the beneficiary and that the letter was intended to be a first written demand on the beneficiary's behalf. The judge pointed out that it was seemingly common cause that the principal agent was indeed acting on behalf of the beneficiary when the demand letter was written.[165] Accordingly to

[164] *University of the Western Cape* (n 125) par 1.
[165] See par 10.

Fourie J, the issue was therefore whether performance by a representative could be regarded as strict compliance with the terms of the guarantee. [166]

The judge dismissed the guarantor's defence and said that it was common cause that the principal agent was acting on behalf of the beneficiary, and that representation or agency is generally accepted by the business community. Fourie J found that, in the case before him, there was no requirement that the beneficiary act personally in calling up the construction guarantee. He added:[167]

> "[T]here is no term or condition in the guarantee which explicitly excludes performance by a representative or an agent on behalf of the employer. I am also unable to find that such a term or condition should be inferred by necessary implication. The note at the end of the guarantee referring to the 'Employer's duly authorised agent' relates to the return of the original guarantee before payment will be made. The intention was, so it appears to me, to ensure the return of the original guarantee before any payment will be made and not to authorised representation only in this instance."

Fourie J therefore concluded that there was "no merit in the defence relating to representation".

The judge proceeded to deal with the second defence of the guarantor, namely the alleged impropriety of the call by the beneficiary. There were two main disputes concerning the underlying contract raised by the guarantor: first, concerning the issuing of a practical completion certificate, and secondly, that the cancellation of the underlying contract by the beneficiary was unlawful and also contrived. The contractor (applicant of the construction guarantee) apparently denied that it had received a practical completion certificate. From the evidence placed before court by the beneficiary, Fourie J, however, found that a practical completion certificate had in fact been sent to the contractor and there was no evidence before him that indicated that the beneficiary had falsified the proof that it had sent the said certificate.

Fourie J confirmed that the beneficiary did not have to prove to the court that it had validly cancelled the underlying contract due to the contractor's default. "[A] dispute with regard to the question whether or not the applicant was entitled to cancel the contract is irrelevant and does not entitle [Guarantor] to raise it as a defence".[168] Fourie J said the only defence would be to allege and prove that the beneficiary had committed fraud in this regard. The guarantor carried the onus to prove clear fraud. The guarantor was convinced that the cancellation of the underlying contract was contrived, because in its opinion the beneficiary knew the underlying contract had not been cancelled on account of the contractor's default. Fourie J nonetheless, stated "[i]t is not sufficient to say the contractor holds the view that the call was made in bad faith as this may probably only indicate the existence of a dispute between the applicant and the building contractor with regard to the question whether or not the applicant was entitled to cancel the contract". [169] As a result, the court concluded that the guarantor had failed to prove that a fraud was committed by the beneficiary and, accordingly, the application had to succeed. The court entered judgment in favour of the beneficiary and ordered the guarantor to pay the amount claimed (ie, R13 128 265.71) plus interest and the costs of the legal proceedings.

If one considered the different clauses and the general wording of the construction guarantee, as evident from the facts of the matter as set out in the

[166] par 10.
[167] par 12.
[168] par 18.
[169] par 21.

judgment, particularly the different definitions given to the parties (ie, the employer, contractor and principal agent) in the guarantee, clauses 5 of the guarantee calling specifically for the "first written demand from the Employer to the Guarantor", and the note on the last page of the guarantee calling for either the employer or the Employer's duly authorised agent to return the original construction guarantee if a call was to be made, it is quite possible to conclude that a clear distinction is drawn between what the different powers and obligations of the beneficiary and its principal agent ("duly authorised agent") are.[170] It is even conceivable to construe the construction to mean that the demand had to be made by the beneficiary itself. Fourie J, however, was of the view that there was nothing specifically in the guarantee that prohibited the principal agent to make the demand on behalf of the beneficiary. The *University of the Western Cape* case shows clearly how difficult it can be in practice is to construe a demand guarantee properly. If Fourie J were to have given the words in clause 5 of the construction guarantee which called for a *first written demand from the Employer to the Guarantor* their ordinary grammatical meaning, he might have reached a different conclusion and could have found that there was, in reality, no compliance as the demand stipulated that the demand had to be made by the beneficiary (employer). However, in deciding the matter Fourie J took a different approach and rather followed a similar approach to the one taken by Satchwell J in *Kristabel,* seemingly implying that strict compliance with the terms of a construction (demand) guarantee is not required.[171]

The court in *University of the Western Cape* upheld the independence principle of construction guarantees, by holding that only fraud would constitute a valid exception to the independence principle. This is in line with the recent judgments delivered by the South African Supreme Court of Appeal on the matter.[172]

### 5 *A few comments*

The modern "matrix of facts" method of interpretation of contracts, including commercial instruments, as approved and applied by English and South African courts, means that if there are two possible constructions when interpreting a commercial instrument, such as a demand guarantee or letter of credit, the courts are permitted to prefer the construction which is consistent with business common sense and to reject the other.[173] However, this modern method of construing commercial instruments is not without its problems. The main problem that arises when this method of interpretation is used for commercial instruments is to decide where to draw the line between avoiding a "commercial absurdity" and honouring these instruments' documentary nature and independence from their underlying contracts. It is difficult to determine what exactly would constitute a "commercial

[170] For a similar view, see Scott, N Gabryk and K Swart "On-demand bonds: Is substantial compliance enough?" (14 December 2015) available at http://www.clydeco.com/insight/updates/view/on-demnand-bonds-is-substantial-compliance-enough last accessed on 4 October 2016).

[171] For more on the application of strict compliance to demand guarantees, particularly in terms of the South African law, see Kelly-Louw (n 40 (2016)).

[172] See, eg, *Firstrand Bank Ltd* (n 35); *Coface* (n 44). For a recent discussion of the fraud exception in South Africa, see Kelly-Louw (n 45 (2014) 197–218. However, in a recent a High Court case in South Africa it was held that there were also other exceptions, besides fraud (see *Sulzer* (n 46); for a brief discussion of this case, see Kelly-Louw "*Sulzer Pumps (South Africa) (Proprietary) Limited v Covec-MC Joint Venture*"(1672/2013) [2014] ZAGPPHC 695 (2 September 2014) [South Africa] (May 2015) Vol 19(5) *Documentary Credit World* 17–22).

[173] Furmston and Chuah (n 16) 382.

absurdity" when dealing with commercial instruments such as demand guarantees. This modern method of interpretation will probably work well in instances when a court needs to determine what type of commercial instrument has been created, for example, whether it constitutes a suretyship agreements or a primary guarantee – as was done in the *Mutual and Federal* case. However, it is to be doubted whether this contemporary method of construction will also work well for deciding what would constitute a compliant demand. Chuah rightly points out that "there is a danger of the courts substituting its own judgment of the commerciality of the transaction for that of the parties or, indeed, the industry".[174]

It is not only the English and South African courts that are divided in their opinion as to whether or not a less strict standard of compliance applies to demand guarantees. International academics and lawyers also hold different views on the matter.[175] The only issues the courts and all commentators seem to agree on is that a demand for payment under a demand guarantee must comply with any requirements stipulated in the guarantee and that the principle of strict compliance can and must be applied to demand guarantees to the extent that the wording of the guarantee makes it appropriate.[176] The heart of the matter lies in a proper interpretation of the demand guarantee. The wording of a specific guarantee should be construed in order to establish whether or not a beneficiary is permitted to receive payment in terms of the guarantee.[177] It is, therefore, vital that a proper interpretation is made to determine exactly what the demand guarantee requires.[178]

Staughton LJ who delivered the judgment for the English Court of Appeal in the *IE Contractors* case[179] made a valid point regarding the degree of documentary compliance required for a demand guarantee. He emphasised that the degree of compliance might be strict or less strict, depending on the construction of the guarantee.[180] The essence of the matter is, therefore, not whether strict compliance applies or not to a demand guarantee, but rather whether there has been compliance and whether what was called for in the guarantee was truly submitted or not. It has aptly been said, that it does not matter what the controversy is regarding the application of strict compliance to demand guarantees, as "it is naturally open to the parties to make strict compliance a condition".[181]

The same strict standard of compliance should apply to commercial letters of credit and to demand guarantees. However, I also share the view of other commentators and courts that the standard of strictness required for a guarantee is to be found in its terms and the wording used.

Courts are cautioned to not simply follow this modern "matrix of facts" method of interpretation when deciding what would constitute a compliant demand for demand guarantees. A court should always firstly respect the documentary and independent nature of a demand guarantee and try to adhere to precisely what the guarantee calls for, especially if that is set out clearly in its terms, even if it might seem commercially absurd to the court. After all, the commercial purpose

[174] ibid.
[175] For a discussion of the different views, see Kelly-Louw (n 40 (2016)) 108–113.
[176] Kelly-Louw (n 40 (2016)) 126; Malek and Quest (n 32) 367, 369; Hugo (n 108 (2014)) 163; Enonchong (n 111) 86–87.
[177] Malek and Quest (n 32) 367.
[178] *Esal* case (n 59); Chuah (n 42) 627.
[179] (n 101).
[180] *IE Contractors* case (n 101) 501–502. See also Enonchong (n 111) 88.
[181] Furmston and Chuah (n 16) 382.

of a demand guarantee should take centre stage when a determination is made as to what is required to make a demand. For example, in the *Siporex* case[182] Hirst J correctly said:[183]

> "The whole commercial purpose of a performance bond is to provide a security which is to be readily, promptly and assuredly realisable when the prescribed event occurs; a purpose reflected in the provision here that it should be payable 'on first demand'."

Therefore, when a court is required to construe words used in the demand guarantee it must give the words their ordinary grammatical meaning in order to determine the parties' intention, unless they constitute clear examples justifying an application of the "surrounding/background circumstances" or "matrix of facts" method of interpretation. Neither the court in *Kristabel* nor the court in *University of the Western Cape* applied this modern-day "matrix of facts" method of interpretation. In any event, it is doubted whether the facts in *Kristabel* warrant a deviation from a strict standard of compliance and would justify the application of the "matrix of facts" method of interpretation to achieve a more "commercial" interpretation. However, the facts in the *University of the Western Cape* case might justify such an interpretation.

Of course, where following a literal interpretation of a clause of a demand guarantee would lead to a "commercial absurdity" I agree that such an interpretation should not be followed and that a "less" strict standard of compliance should then be applied. But only in clearly exceptional circumstances, for example, where the words are definitely ambiguous and, as suggested by Bertrams, if doing so, would not harm specific justified interests of the guarantor.[184] There is no justification for a general relaxation of the principle of strict compliance regarding all demand guarantees.[185]

[182] (n 59).
[183] the *Siporex* case (n 59) 158.
[184] Bertrams (n 34) 140, 145; Kelly-Louw (n 40 (2016)) 109.
[185] Kelly-Louw (n 40 (2016)) 128–129.

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# Trade finance and the Banking Commission of the ICC

MARIA EUGENIA ZOZAYA IRUJO*

## 1 *Introduction*

International legal relations are based on a relatively small number of contractual figures, such as purchase, joint venture, licensing or construction agreements. These international contractual forms are the principal obligations. However, in order to achieve the ultimate economic purpose of the agreements referred to, it is necessary to rely on a series of accessorial techniques that can be, at the moment of truth, of a total transcendence. The success of an international transaction relies on the satisfaction of the involved parties' expectations: one party's expectation will be to be paid; and this is where trade finance comes into play.

Trade is becoming more and more complex every day because of the increasing technical difficulty of carrying out the agreed supply or service. More difficulty implies, many times, a delay in the execution of the supply or the provision of the services with the consequent risk of unpredictability. The evolution of banking intervention in international trade corresponds to the necessary response to give certainty to payments involved in trade.

Within international trade, main players are out of their comfort area, as there are so many difficulties to be faced, namely, inter alia: (i) the geographical and cultural distance of the players; (ii) the multiplicity and complexity of the involved parties (customs agents and authorities, banks, insurers, carriers, operators, tax or health authorities, forwarders, consignees, etc); (iii) different languages; (iv) different laws; (v) different currencies; (vi) the exporter's lack of experience; (vii) the exporter's lack of human resources; (viii) the parties' lack of knowledge of the market; (ix) the lack of knowledge between the counterparties themselves; and (x) different bargaining positions.

Of particular interest is the difficulty concerning different laws. Conflicts can arise from the different laws applicable to, for example, the awarding of the works, the law applicable to the construction contract and the payment instrument (including the possibility that the payment instrument or its guarantee is made up of a chain of instruments each subject to different laws). Also, we should not forget different competent jurisdictions or other dispute resolution mechanisms, with the huge problem of the potential lack of recognition and enforcement of the judgment.

Guarantees and letters of credit are the most significant trade finance instruments. These are irrevocable payment commitments assumed by, generally, financial institutions on behalf of third parties for the benefit of beneficiaries, usually foreign, independent of the underlying principal obligation. They were born as substitutes for security deposits, to eliminate the need to engage the treasury of

* Head of the Caixabank's International Legal Department (in Spain); member of the Legal Committee of the ICC' Banking Commission.



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companies or having to borrow money with important financial expenses. They have become indispensable instruments as they have simplified international traffic. However, it is important to note that the rigor and formality of the trade finance instruments make them very useful and at the same very dangerous.

Financing entities play a decisive role in foreign trade, as they can be crucial for the financing of the underlying transaction and the management or assurance of its payment methods, their liquidation and collection.

### 2 *How do financing entities issue guarantees or documentary credits on behalf of their clients?*

It is important to provide some context: commercial contracts are negotiated between exporters and importers, and in particular, between their respective business people. These individuals have a deep knowledge of the companies' products, needs or financing situation. They negotiate the price, conditions for the delivery or reception of the services or products, warranty terms, liabilities and guarantees really professionally. They have the big ideas and they write them down roughly, without legal advice. It is considered that the fewer lawyers are involved, the better for the business.

Within the optimistic atmosphere of the signing of the commercial contract, the parties' representatives feel that legal counsel is a burden and hinders the business, so it is justified to save the cost of lawyers. Despite the fact that this might be true sometimes, it can be a mistake that can turn into big trouble.

Regardless of other legal aspects that may arise when negotiating commercial contracts involving trade, there might be tricky legal questions concerning trade finance instruments. The review of the documentation by specialized legal counsel can avoid some of the potential legal issues. When it comes to trade finance instruments, details matter a lot, and prepared lawyers can be of much help.

By way of example, commercial people may not be aware of how important it is to define in a precise manner the guaranteed obligation under a first demand guarantee. The terms of the guaranteed obligation are absolutely relevant so that the parties have a right to sue for fraudulent execution of the guarantee as the case may be. For instance, the typical definition of the guaranteed obligation in a performance-bond type should not be accepted by the beneficiary if its intention is that the guarantee should cover the non-execution of the commercial agreement. Are the commercial people aware enough of these tiny details that can make an enormous difference when troubles arrive?

Once exporters and importers have reached an agreement on the commercial contract, they have very little strength left to negotiate the details of the guarantees and documentary credits. This puts the trade finance instruments into the same position as the famous "midnight clause" in agreements (*i.e.* the dispute resolution clause). That is, trade finance instruments are tackled at the end of tough negotiations where no special consideration is put into them. This could well end up representing a huge mistake due to the consequences that improper texts may

entail to the parties involved. It would be a good idea to incorporate proper legal advice at a very early stage and for this specific purpose. Details matter a lot.[1]

Clients approach the financing entities when very little time is left to fulfill the commitment of having issued the guarantee or documentary credit. Sometimes they even go to their banks when they should have already had the instruments in place. Banks need some time to do their job, basically: (i) analyze the credit risk of the client; (ii) review the texts carefully and check them in the light of internal approvals (term of the instrument, amount, legislation, special conditions); (iii) pass regulatory checks; and, as the case may be, (iv) negotiate with local banks for, for example, confirmation or counter-guarantees.

At the time of issuance of the instruments, clients usually are in such a hurry and under such pressure coming from the beneficiary of the instruments that they just want to have the texts issued, as they are, as soon as possible. Banks sometimes propose changes to make the texts clearer and less risky to the client (guaranteed party or applicant for the documentary credit) and/or to the bank itself. However, these proposals are hardly ever accepted by the client and are seen as a lack of support from the bank to accompany clients in doing business abroad.

This, however, often leads to the so-called "boomerang effect". The bank issues the trade instrument that lacks clarity in order to support the client... but then the lack of clarity ends up being crucial in order to evaluate, for example, whether the bank has received a complying demand or presentation of documents from the beneficiary of the instrument. The supposed support given by the bank to the client by issuing an insufficiently clear documentary instrument leads to with irreconcilable differences between the two most beloved, related and well-known parties: the bank and its client. It is important to educate trade finance players to understand that clarity benefits all interveners and the success of the transaction itself. The importance of clarity is obviously not something new to the parties, but the rush so often leads to interveners forgetting about it.

### 3 *Attempts to prevent payment*

Only once a high voltage point in time is achieved, and the tension between the guaranteed party or the issuer of the instrument and the beneficiary is irreconcilable, does the bank's client contract a good legal firm to prevent the bank from paying the instrument. Then, the legal firm usually tries to stop the bank's payment by sending it threatening official communications wherein they explain the lack of grounds for the beneficiary to collect on the instrument and how illegally the bank

[1] First demand guarantees have many aspects to be carefully considered by clients and their lawyers, such as:

- Guaranteed obligation: as mentioned above, this is something crucial for the client and it is to be thoroughly reviewed by the parties and their lawyers. By contrast, from the bank's perspective this is something irrelevant.
- Term: is it determined or determinable? Is the date mentioned in the guarantee an expiry date or is it the coverage period of the guaranteed obligations?
- Maximum amount: does the guarantee have a maximum amount or does it contain indemnities?
- Assignment: is the guarantee assignable independently of the guaranteed obligation?
- Conditions: does the guarantee contain non documentary conditions?
- Multiple parties: does the guarantee have multiple beneficiaries or multiple guaranteed parties? How do they act?
- Number of guarantees: is the beneficiary receiving various guarantees from different guaranteed parties/guarantors? Is the beneficiary entitled to claim payment of the guarantees proportionally?

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would be acting if it were to pay. These notifications are, usually, pointless. Banks are going to pay unless a real fraud is proved – and that is really complicated.

Then the legal advisors will try to obtain precautionary measures from the judge to order the bank not to pay. It is important, however, to consider whether stopping payment of these documentary instruments is good for international trade? It is suggested that the answer to this question must be in the negative. In this regard the following statement of Lord Denning in *Power Curber International Ltd v National Bank of Kuwait SAK* deserves to be supported:

> "[…] a letter of credit is given by a bank to the seller with the very intention of avoiding anything in the nature of a set-off or counterclaim. This is borne out by the Uniform Customs and Practice for Documentary Credits which have been adopted by the banks in all, or practically all, the countries of the world, from China to Andorra, from Cuba to Nauru. All subscribe to the Uniform Customs and Practice which declare in the general provisions and declarations '… (c) Credits, by their nature, are separate transactions from the sales or other contracts on which they may be based and banks are in no way concerned with or bound by such contracts … '
>
> *If the court of any of the countries should interfere with the obligations of one of its banks (by ordering it not to pay under a letter of credit), it would strike at the very heart of that country's international trade.* No foreign seller would supply goods to that country on letters of credit because he could no longer be confident of being paid. No trader would accept a letter of credit issued by a bank of that country if it might be ordered by its courts not to pay. *So it is part of the law of international trade that letters of credit should be honoured and not nullified by an attachment order at the suit of the buyer.*"[2]

More recently, the Spanish Supreme Court[3]has also ruled against allowing precautionary measures in the context of a first demand guarantee:

> "[…] the suspension of the execution of this type of guarantees at the request of the debtor as a result of a dispute arising in the main contract is contrary to its legal nature since they are autonomous, independent, distinct and non-accessory [... ]."

It is important to note that the conflict of laws and jurisdiction within the context of a sequence of guarantees and counter guarantees is not solved yet. If payment of part of the sequence is stopped by precautionary measures, it will have consequences for all the participants involved in the transaction, giving rise to an extremely complicated and costly legal situation. This is certainly to be avoided.

Lawyers should be encouraged not to file precautionary measures against the banks to prevent them from paying unless there is a clear presence of actual fraud. Commercial disputes should be left aside from trade instruments. Otherwise, international trade will be seriously harmed. There is a chain of events. If a country becomes known because its national courts issue attachment orders or interdicts preventing banks from paying their trade instruments, that country is likely to be cut out to a great extent from the trade finance world. Banks from that country will not be acceptable for the beneficiaries and/or foreign banks with the concomitant result of that country's exporters and importers being severely harmed.[4]

[2] *Power Curber International Ltd v National Bank of Kuwait SAK* 1981 1 WLR 1233 (CA) 1241c-f (my italics).

[3] STS 398/2014 17th July, 3rd legal ground (*Fundamento de Derecho*).

[4] In this regard it is of interest to note that the number of banks from the Middle East that request that the counter-guarantees that they receive should contain a commitment from their counter-guarantor to pay the counter-guarantee notwithstanding any potential judicial attachment, is on the rise.

Specialized lawyers should help structuring transactions from the outset and draft trade instruments carefully so that they are clear and the parties know what the rules are. They should think up alternatives or ideas to minimize the risks undertaken by the rigor of the instruments. For example, in important commercial agreements (especially construction agreements), and in particular, with reference to trade instruments, lawyers can work on the idea of incorporating dispute boards[5]. The inclusion of a requirement stating that in order to claim payment of a trade instrument (and, in particular, of first demand guarantees) a favorable resolution of the appointed dispute board is needed, could be a good intermediate solution to balance the rigor of the instrument.

Anticipating the intervention of good trade lawyers in commercial contracts could reduce disputes in trade finance. In addition, specialization in this legal field by big legal firms will also be of significant importance.

### 4 *International regulation*

The International Chamber of Commerce has played a decisive role by standardizing the practice and the rules of trade finance instruments. Although these rules are voluntary, they are observed in thousands of transactions every day. The rules level the playing field among the different interests of the parties involved in trade instruments.

Despite the absence of a uniform international trade law, trade instruments (especially documentary credits) enjoy an impressive uniformity in the international context. This can in large part be ascribed to the work of the International Chamber of Commerce (ICC). This organization is described in some detail in Annexure 1 below.

One of the essential tasks of the ICC is to provide services that facilitate trade. Thus, the ICC has stood out in the collection and formulation of uniform commercial usage worldwide.

The legal nature of the rules of the ICC has been dealt with by different legal commentators. On the one hand, courts in some countries regard the ICC rules as special regulations comparable to customary law that can be imposed, *ipso iure*, on the contracting parties (unless otherwise specified). By contrast, in other countries, it is thought that the provisions of the uniform rules and uses only bind the parties to the extent that they have expressly so agreed. By way of example, in Spain, ICC rules have a contractual consideration and therefore apply by express reference of the parties – although we can find some case law where the Spanish courts have indirectly interpreted certain UCP articles as customary law.[6]

Legal authors have argued that the origin of the ICC standards, developed unilaterally by a private international organization that are subsequently amended, makes it difficult to consider these rules as constituting a "legally binding generalized social awareness" and, therefore, custom. It may be less problematic to consider the rules as interpretive uses of the will of the parties.

[5] Dispute boards were initially created as a tool for construction contracts. It is a pre-arbitration tool, set up at the outset of the project whereby the expert board members, upon request, provide prompt recommendations. These recommendations have a binding effect until they are reversed by the competent arbitration or court.

[6] Spanish Supreme Tribunal 1984/7444 27th October.

Not only the role of the international rules within the national legal framework is debated, but also how the rules themselves should be understood and applied by the courts. In this regard the Singapore Court of Appeal has recently ruled[7] in (in what is destined to become a famous case),[8] *Grains and Industrial Products Trading Pte Ltd v Bank of India*[9] that, based on the test of necessity for the implication of a term under Singapore law, a "purposive approach to construction [of the Rules was] appropriate" and this should "reflect 'the best practice and reasonable expectations of experienced market practitioners". [10] The judgment continues stating that "no uncertainty can arise from giving effect to the normal expectations of parties to a transaction".[11]

The Singapore Court also accepted the position expressed by the English Court of Appeal in *Fortis Bank SA/NV and another v Indian Overseas Bank*[12] that the international nature of UCP 600 must be appreciated when construing its provisions:

> "[A] *court must recognise the international nature of the UCP and approach its construction in that spirit*. … Courts must therefore interpret it in accordance with its underlying aims and purposes *reflecting international practice and the expectations of international bankers and international traders* so that it underpins the operation of letters of credit in international trade. A literalistic and national approach must be avoided."[13]

However, there was a dissenting opinion by Chan Sek Keong SJ, who held a different view to that expressed by the majority of judges. In this regard he explained as follows:

> "*It may not be wise for national courts to act as super-drafters of the UCP*. The court will no longer be construing the UCP but reconstructing it to meet its own understanding of the purpose of the particular article. It is suggested that this is not the business of the courts to cause a regime change in the law and practice of letters of credit under the UCP. *It is suggested that if there is a lacuna in UCP 600, the lacuna should be filled by express contractual terms or by revising UCP 600*."[14]

Even though the rules are not perfect and they may lead to debate as to their applicability and interpretation, they provide certainty and clarity within international trade relationships. The rules are an important pillar for trade.

[7] The judgment revolves around the duty as to when and when not a nominated bank should forward documents, as this is not expressly set out in article 15(c) of the UCP.

[8] It will be famous as the ruling also provides that a nominated bank is an agent of the issuing bank by reason of the authority that the issuing bank confers upon the nominated bank. "An agency relationship will be found when a nominated bank acts on the issuing bank's mandate because when it does so, it has the power to affect the issuing bank's rights and liabilities as against the beneficiary on matters so authorized." This is argued by dissenting Chan Sek Keong SJ.

[9] 2016 SGCA 32 (23 May).

[10] In this decision the Court took the approach of *Fortis Bank SA/NV v Indian Overseas Bank* 2010 2 All ER (Comm) 28 43 to construing and implying terms into UCP 600.

[11] The Court makes a purposive interpretation of article 15(c) of the UCP and holds "[…] that documents should be forwarded by a nominated bank under article 15(c) promptly once it has assessed that the presentation is complying and it honours or negotiates the credit, and also [that] […] this means by the end of the next business day after the determination has been made unless there are compelling reasons for any delay". The unstated purpose in article 15(c) is said to be "the foundation on which the article rests" and is consistent with "the expectation of the market". Again, this is argued by the dissenting Judge who states that "it is not permissible to imply a common law duty, whether in agency law or otherwise, and superimpose it on Art 15(c) or to run parallel with it. The obligations, if any, of Bank of India are set out in Art 15(c) and not under the common law." (287.)

[12] 2011 2 Lloyd's Rep 33 (CA).

[13] A point made (*per* Thomas LJ) at para 29 (my italics).

[14] par 265 (my italics).

### 5 *How to improve certainty in international trade?*

As mentioned above, international trade faces multiple factors that may give rise to uncertainty for the parties. This uncertainty lies in one of the commercial parties' aim to be paid and the other's on not to pay if certain conditions have not been met. Trade instruments such as documentary credits and first demand guarantees, subject to the uniform rules of the ICC, can contribute towards addressing the lack of confidence between the parties. Because of the rigor of the instruments, they need to be used consciously and carefully. Everybody is aware of the fact that in trade finance, as well as in any other international business, it is vital to avoid judicial conflicts as there is the inconsistency between the ideal rule of law that provides idealized certainty and the varying and inconsistent case law within various jurisdictions and/or within a sole jurisdiction.

For this purpose, the following practical ideas should be taken into consideration:

- Anticipation: parties to commercial agreements should not leave the negotiation and the drafting of the trade instruments to the day before the instruments are supposed to be in place. Anticipation also implies involving legal advisors or trade experts in the revision of the instruments at the time of structuring the transaction.
- Accompaniment of the bank: parties to commercial agreements should involve their banks as soon as possible – even when the negotiations to close the deal are still happening. It is important for the bank to have sufficient time to carry out its internal work to be ready to issue the instruments. Banks have trade experts who know international practice well and see the big picture of the transaction (for example, when there is a chain of counter-guarantees). It is important for the client to consider their bank's recommendations when approaching the trade instruments or the structuring of the transaction.
- Sharing knowledge: deep trade-finance knowledge outside banks is not as common as it should be. Finance and legal sectors should share their respective specialized knowledge as much as possible.
- Following up the transactions: commercial parties and banks should always be on top of transactions. Therefore, it is important to work with banks with excellent back-office service and managers. All parties involved should never lose track of trade transactions.
- Clarity: special attention to the use of language.
- Big picture: all the parties involved should see the transaction as a whole.
- Attention to drafting details: they are of much relevance.
- Negotiation: commercial parties should not disregard comments from experts (internal or external legal advisors or banks) on the grounds of the rush to close the transaction or the differences between bargaining positions. Fight the wording as much as necessary to have clear texts in place.
- Enhance business self-regulation.

The following guidelines could also be taken into consideration and be built on by all players (companies, associations, banks, multilaterals, judicial systems, arbitration chambers) in order to improve international trade:

- Consider a globalization of law: not a total unification, but it would be good to create cross-border spaces and a global private horizontal legal framework.
- Solve the conflict amongst existing private legal orders, whose recognition and effectiveness depend on national courts. The problem with local interpretation by judges should be solved by integrating national and international jurisdictions. It would be very positive to create a specific forum for international economic transactions with clear criteria for a fast uniform interpretation, to be reasonably foreseeable.
- Enhance the dialogue between ordinary jurisdiction and alternative mechanisms for the settlement of private disputes.

– Support judicial specialization (international trade, investment, intellectual property, international contracts).

**Annexure 1**

An overview of the ICC[15] and its Banking Commission, as well as of the Legal Committee of the Banking Commission and the Banking Commission's Task Force on Guarantees

1 *The origins and development of the International Chamber of Commerce*

Chaos reigned Europe and in much of the rest of the world after the devastation of World War I. Most areas and sectors were devastated, including those relating to trade, investment, finance and commerce. There were very few working international structures and no international rule of law for business. Within this context, a group of industrialists, financiers and traders that called themselves "the merchants of peace", decided to create an organization that would represent business everywhere, which became the International Chamber of Commerce. The founders were businessmen from five different countries.

The ICC's first president, Etienne Clémentel, a former French Minister of Commerce, established the new organization's international secretariat in Paris. Mr Clémentel was crucial in creating the ICC International Court of Arbitration in 1923.

The ICC served on the Dawes Commission, which drew up the international treaty on war reparations in 1924.

The ICC issued the first version of its Uniform Customs and Practice for Documentary Credits (UCP) in 1933, the international commercial terms (Incoterms) in 1936, and its first International Code of Advertising Practice in 1934.

The United Nations (UN) awarded the ICC with the highest level consultative status in 1946, since which the ICC has represented the private sector by engaging in a broad range of activities with the UN and its specialized agencies.

The ICC has remained a diligent advocate of the open multilateral trading system through successive trade rounds, including the Doha Round.

The ICC, in its constitution, pledges "to further the development of an open world economy with the firm conviction that international commercial exchanges are conducive to both greater global prosperity and peace among nations".

2 *The internal organization of the ICC*

The ICC presents itself as the "world business organization". It is an organization with hundreds of thousands of member companies in more than 120 countries. Members include many of the world's biggest multinationals as well as small- and medium-sized companies.

[15] http://www.iccwbo.org/about-icc/.

The ICC works through national committees[16]. National committees coordinate with their members to address the interests of the business community and to convey to their governments the business views and concerns formulated by ICC's members. In countries where there are no national committees, companies can join ICC individually by becoming direct members.

The ICC makes policy through its 13 commissions. These are specialized working bodies composed of business experts who examine major issues of interest to the business world. They prepare policy products, including statements to contribute to inter-governmental discussions, as well as rules and codes to facilitate international business transactions. Policy is made in: arbitration,[17] banking, commercial law, competition, corporate responsibility and anti-corruption, e-Business, IT and telecoms, environment and energy, intellectual property, marketing and advertising, taxation, trade and investment, and customs and trade facilitation.

The strength and legitimacy of ICC policy statements and rules are derived from the fact that they are developed through extensive consultation with member companies. The ICC's normal consultative procedure requires policy documents first to be adopted by one or more commissions, in consultation with national committees, and then approved by the Executive Board, before they can be regarded as official and public ICC positions.

The ICC is dedicated to business self-regulation and has issued a large variety of voluntary rules, guidelines and codes to facilitate business and to spread best practice. It also issues model contracts that companies can adapt to their needs, shortening the time they spend on negotiations, saving costs and encouraging trade.

### The Banking Commission of the ICC

The Banking Commission is the largest commission of the ICC and it has more than 80 years of experience. It is made up of more than 600 members in more than 100 countries and is one of the key players in the field of trade finance.

The officers of the commission are appointed by the ICC Secretary General and generally serve for a three-year renewable term. Members are chosen by ICC national committees amongst their respective members to serve first on their local Banking Committee and then to represent the national committee at the plenary commission meetings. These meetings are generally held twice a year. Members remain as long as their national committee wishes them to serve.

[16] There are national committees in the following countries: **Africa**: Algeria, Burkina Faso, Egypt, Ghana, Kenya, Morocco, Nigeria, South Africa and Tunisia. **America**: Argentina. Bolivia, Brazil, Canada, Caribbean, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, Guatemala, Mexico, Panama, Peru, Paraguay, United States, Uruguay, Venezuela. **Asia & Pacific**: Afghanistan, Australia, Bangladesh, China, Hong Kong, India, Indonesia, Japan, Korea, Macao, Malaysia, New Zealand, Pakistan, Philippines, Singapore, Sri Lanka, Thailand. **Europe**: Albania, Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece, Ireland, Italy, Lithuania, Luxembourg, Macedonia, Monaco, Netherlands, Norway, Poland, Portugal, Romania, Russia, Serbia, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine, United Kingdom. **Middle East**: Bahrain, Israel, Iran, Jordan, Kuwait, Lebanon, Palestine, Qatar, Saudi Arabia, Syria, UAE.

[17] Arbitration and alternative dispute resolution mechanisms: probably the best known practice area of the ICC, it plays a key role for resolving domestic and international disputes. ICC Arbitration initiated and led the adoption of The Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Since its inception, the Court has administered more than 20,000 cases involving parties and arbitrators from some 180 countries.

There are a number of task forces, working groups and drafting groups within the Commission.

The Banking Commission is governed by a Chair and it is led by (i) an advisory board, comprised of 12 members. It seeks transparency and standardization of trade finance products; and (ii) an executive committee, comprised of 12 officers each supervising a specific line of service.

The ICC Banking Commission's main workstreams are: (i) Traditional Trade Services; (ii) Open Account and Supply Chain Financing; (iii) Global Regulation; (iv) Legal and Compliance Issues; and (v) Risk and Asset Management.

Current task forces within the ICC Banking Commission are:

- Banking Commission Legal Committee, explained below.
- Bank Payment Obligation (BPO) Education Group: this group was formed to enhance the understanding of the BPOs within the members of the National Committees and to deploy the product internally.
- Task Force on Forfaiting, with the aim to: (i) disseminate knowledge of forfaiting and understanding of the Uniform Rules for Forfaiting (URF); (ii) answer queries and issue opinions on the URF and Forfaiting generally; and (iii) publish educational material on the URF and Forfaiting. The task force is made up of, approximately, 20 members from banks and other financial institutions around the world.
- ICC Register on Trade Finance: this tool enhances the understanding of trade finance products and their risks amongst main players within the financing regulation forces (government, regulatory, industry, and multilateral institutions), making available data on trade and export. The information provided by the Register is very useful to show to regulators and policy makers the low-risk nature of lending and guarantees that support imports and exports. It has also provided data for discussions regarding the treatment of trade financing under the Basel framework
- Task Force on Guarantees: explained below.
- Financial Crime Risk & Policy Group: this group aims to interact with, and draft guidance, policy submissions and response to regulators, industry groups and members on all topics related to financial crime risk issues affecting the banking industry (such as financial crime including financial fraud, tax evasion and other predicative offences related to trade products and services, sanctions regulations and consequences of not understanding the requirements, know your customers and correspondent banking requirements, AML, etc).
- Global Supply Chain Finance Forum Drafting Group: this group was created with the aim to standardize the terminology used in supply chain finance world. This succeeded on 2016, with the publication of the Standard Definitions for Techniques of Supply Chain Finance.

In order to produce or review rules, a drafting group is made up within the Banking Commission. It produces an initial draft which is then sent to ICC national committees for comments. These are considered by the commission as a whole, and revised drafts are produced until a final version is reached. Like this, the rules are global and represent international practices as national committees and members worldwide are involved in their elaboration. Finally, the rules or documents are approved and sent to the ICC Council for formal adoption.

The ICC plays a keen role in making dialogue with governments and intergovernmental organizations on behalf of the private sector and developing international rules, mechanisms and standards that are used every day.

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### The Legal Committee of the Banking Commission

The Legal Committee is a relatively new task force within the Banking Commission. It was incorporated on the 22nd of October 2013, with the aim of: (i) identifying legal topics in connection with the Banking Commission's scope of activities and, if appropriate, recommending specific action to the Banking Commission; and (ii) offering specialist legal advice to other committees, groups or task forces of the Banking Commission.

It is an open forum for discussion amongst specialist lawyers to share best practice and facilitate trade finance.

The membership of the Legal Committee is made up of senior legal officers of financial institutions and specialist outside counsel and academics. It is chaired by Dr Georges Affaki. As of today, the Legal Committee is made up of 34 members who practice in 22 countries and represent 21 banks and 8 law firms.

The Legal Committee deals with issues that have a legal impact on trade finance, such as matters related to sanctions,[18] unilateral jurisdictional clauses, e-bills of ladings or legal risks in warehouse financing. In addition, matters related to European legislation[19] that due to globalization has an impact on finance worldwide are also considered.

### The Banking Commission's Task Force on Guarantees

The Banking Commission's Guarantees Task Force compiles ideas to impact on new policy relating to international guarantees, promotes a wider use of the Uniform Rules for Demand Guarantees (URDG 758), answers queries from users concerning the rules and monitors international guarantee practice.

The Task Force on Guarantees currently consists of 40 members from 24 countries and, as in the case of the Legal Committee, meets twice a year.

It is worthwhile mentioning the relevance of the projects this Task Force is dealing with, such as the collection of local law/local regulations on guarantees and the collection of international standard practice (best practice) as the basis for a codified Standard International Demand Guarantee Practice (like the ISBP for documentary credits).

[18] The use of clauses in relation to trade, economic or financial sanctions or embargos ("sanctions") in trade finance-related instruments that are subject to the ICC rules, stating banks' intention to comply with sanctions regulations, has become a problematic issue for banks involved in trade finance transactions. The Legal Committee helped the Banking Commission on the issuance of the Guidance Paper on the use of sanctions clauses in trade finance-related instruments subject to ICC rules**.** It is available on the ICC's website.

[19] For example, we are currently considering: (i) article 194 of Regulation of the European Parliament regarding capital regulatory requirements (CRR). This article makes European financing entities have an independent written legal opinion confirming that the credit protection arrangements used by that institution are legally effective and enforceable in all relevant jurisdictions; and (ii) article 55 of the EU Bank Recovery and Resolution Directive according to which firms subject to it have been required to include in their non-EU law governed contracts a clause by which the creditor recognizes and agrees that "liabilities" may become subject to bail-in (that is subject to the write down powers of the relevant resolution authorities).

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# Trade finance and the next-generation trade instruments or technologies: what are the implications for banks?

THANDIWE LEGWAILA[*]

## 1 *Introduction*

Trade is the lifeblood of the global economy and banks have long played an important role in mitigating risk and offering financing for both domestic and international trade. Banks help companies finance production and manufacturing, ease working capital, comply with regulations, prevent fraud, and guarantee the credit worthiness of businesses that do not have established working relationships. As trade has become more global, markets have become more competitive, and supply chains have become more complex, financing, risk mitigation, working capital optimisation, and security of funds have become more important in global trade.

Banks also contribute to risk management by ensuring compliance with laws related to Anti-Money Laundering (AML), Counter Terrorist Financing (CTF) Know Your Client (KYC) requirements, as well as compliance with international sanctions and embargoes. Compliance issues can be especially important for businesses buying or selling goods cross-border. As regulatory requirements are constantly changing in many markets around the world, ensuring compliance is a significant enabler of international trade.

Today the biggest challenge in the evolution of trade is that banks' trade finance offerings are not well integrated into the trading cycle. Banks need a holistic view of a corporate's information flows in trade transactions in order to integrate into the natural flow of data that goes on between a buyer and a seller. Banks could then step in to provide value at certain trigger points along the value chain. The reason for this lack of integration is the lack of transparency surrounding trade and trade finance. Trade finance also suffers from costly and time-intensive information matching, often with paper documents that can lead to delays in the transfer of goods, initiation of payment, or release of funds as part of a financing agreement. These manual processes, together with the lack of transparency, also raise the risk of error or even fraud in the case of duplicate invoice financing.

With the rate of change in technology around the world this is set to change. Market acceptance of technology-enabled interactions has come a long way since those early days into digitisation, and corporates to a certain extent are driving this. Digital technology has become an enabling force for corporates along the global physical supply chain. Examples can be taken from Coca-Cola's warehouse automation innovation to Amazon's delivery drones; from Colombian coffee farmers' use of mobile apps to check market prices to Hong Kong International Airport's e-lock and GPS customs clearance systems; players along the chain are harnessing the latest in technology to stay ahead.[1]

[*] Head Documentary Trade Products, Product Management at Standard Bank of South Africa.

[1] www.jpmorgan.com/country/US/EN/insights/treasury-services/a-new-digital-era-for-trade.



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In a recent JP Morgan trade finance client survey, 82% of respondents said that their clients are either thinking about or already moving ahead with trade finance digitisation.[2] The question therefore is what do financial institutions need to do to keep up and avoid being found irrelevant?

Industry stakeholders have made efforts to reduce the impact of some of the challenges facing trade by introducing digitised trade solutions such as bank payment obligations (BPOs), SWIFT for corporates MT798 and electronic bills of lading as delivered by various vendors such as Bolero and EssDocs. Despite the development of these solutions there has been a lack of adoption and a proliferation largely caused by different platforms that lack interoperability and lack of investment by both banks and corporates to take up such solutions, and, lastly, lack of corporates' education. At the back of these digitisation efforts; trade finance has also seen the rise of blockchain technology, which is still at its infancy but promises to transform trade finance.

This contribution deals with these digitisation solutions, looking at their advantages and disadvantages, examines the reasons for their slow adoption and suggests a way forward.

## 2 *The electronic bill of lading*

### 2.1 Introductory comments

Paper bills of lading have been used throughout the world to document and effect international trade for centuries. Yet, whilst the world has become increasingly digitised the paper bill of lading has, on the whole, remained a constant feature of global trade. Its continued use is mainly due to the combined three legal characteristics that it has developed over time namely: (i) it is a receipt of the goods carried; (ii) it provides evidence of the terms of the contract of carriage; and (iii) it is a document of title to the goods.[3] It is these characteristics that have, until relatively recently, foiled attempts to replace it with an electronic format of bill of lading.

### 2.2 Issues with the paper bill of lading

Whilst the paper bill of lading has been used for centuries it is not without its faults, the principal problems being that carriers are obliged to discharge the goods carried on production of an original bill of lading. This is particularly problematic today given both the speed of transport and the fact that the cargo may be sold multiple times during carriage.[4] As a result of this the bill of lading is often not delivered to the consignee in time, and the carrier is often required to accept a letter of indemnity.

The second challenge to the paper-based bill of landing is that it is posted from exporter to exporter bank for scrutiny in line with a letter of credit and then sent to the import bank by post or courier for document checking and negotiation. This process entails the physical movement of documents that exposes them to theft and loss frustrating the importer when it has to clear its goods from the carrier. This

[2] www.sibos.com/media/news/new-digital-era-trade

[3] Hare *Shipping Law Admiralty Jurisdiction in South Africa* (2009) 721-723; United Nations Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea (New York, 2008) (the "Rotterdam Rules").

[4] As the vessel engines improved and handling of cargo and the terminal streamlined the transportation time of cargo has improved significantly. Port authorities are constantly investing in the upgrading of the port to improve cargo clearing time. See *Transnet Market Demand Strategy* (2012).

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again necessitate the importer to obtain the shipping indemnity often acquired from the bank at an additional cost that indemnifies the shipper against any damages that he might suffer as a result of releasing the goods without the original bill of lading. This indemnity does not, however, remove the carrier's liability under the bill of lading and creates an additional administrative burden and cost to the trade.

The other associated challenge is that the paper system is hugely expensive (such cost is estimated to be between 5% – 10% of the value of the goods carried each year. It is an established practice in documentary credit transactions that it calls for 3 original copies of the bills of lading and 3 sets in duplicate certified (one for the exporter/shipper, one for the shipping line and one for receiver/consignee of the goods). The purpose of the requirement is such that each original copy is kept on file for the carrier, freight forwarder and customs as evidential proof that the goods were cleared on presentation of original documents. Lastly, the paper bill of lading may be forged with relative ease and carriers are liable for misdelivery against a forged bill of lading.[5]

### 2.3 Benefits of an electronic bill of lading

The electronic bill of lading or e-bill, in theory, addresses many of the flaws of the paper system, bringing with it a number of advantages: (i) it can be sent around the world instantaneously, hugely lowering the administrative burden of trade (especially where cargo is subject to multiple transfers of ownership during carriage); (ii) any amendments or corrections required can be made far more efficiently and cost effectively without the movement of paper which can create issues regarding which version is valid; and (iii) electronic payment systems, and related advances in security, make an electronic system considerably more secure than its paper equivalent.

These benefits are sure to cut the administrative costs of trade significantly and reduce, if not eradicate, situations where carriers discharge their cargo against letters of indemnity. Today importers incur costs of obtaining the letter of indemnity from the bank over and above the demurrage and storage costs.

### 2.4 Reasons for the slow uptake

Despite the obvious advantages of electronic bills of lading there has been a slow adoption of this innovative solution. There are various vendors that work with trade supply-chain stakeholders that provide this solution. The banks that are supposed to be proponents of this solution are left behind. One of the main reasons for the lack of adoption of the electronic bill of lading is the fact that it is not treated in the same manner in law as its paper equivalent. As stated above a paper bill of lading is a document of title, enabling it to be negotiated and transferred, as possession of the bill is evidence of title to the goods. This is not automatically the case with an electronic bill of lading, and various jurisdictions have differing interpretations of the position in this regard.

The Hague Rules / Hague Visby Rules (HR / HVR)[6] apply to a contract of carriage by reference to the bill of lading, or similar document of title and it has been less clear whether they would apply to any electronic trading system used.

[5] United Nations Commission on International Trade Law (UNCITRAL) Working Group on Electronic Data Interchange 30th session Vienna, 26 February – 8 March 1996.

[6] The Hague-Visby Rules – The Hague Rules as Amended by the Brussels Protocol (1968).

The solution developed to these legal obstacles is essentially a multiparty contract. This takes the form of a set of rules to which users of an electronic trading system are all required to subscribe in order to use the vendor system. Such rules then set out the specific form of electronic trading documentation to be used and that the consequences of using such documentation shall mirror the position at law as if they were paper bills of lading.

This, however, means that electronic trading systems such as BOLERO, which has been in existence since the 1990s, are only able to function between their members (ie those that have agreed to the uniform set of rules and systems that will govern their transactions).[7] Where a member of an electronic trading system enters into a transaction with a non-member, the electronic system cannot be utilised and a paper bill of lading is issued. This feature has limited their growth, as electronic trading systems are only really effective once they have a large number of members, and it is not cost-effective for traders to join until there is a large membership.

The benefits of electronic trading systems are particularly evident to container carriers (as there is often a separate bill of lading for each container carried) and as such have been utilised by liner companies before wider adoption in the industry. However, the efficiencies of electronic trading systems are not confined to the container industry alone and with members of the largest trading companies, trade finance banks, mining companies and oil majors using such systems, it is clear that they are becoming increasingly prevalent in the shipping industry as a whole.

Looking at America and Europe the Baltic and International Maritime Council (BIMCO) included an e-bills clause in its latest iteration of the NYPE form. In summary the new clause provides that: (i) use of an electronic trading system is at charterers' option; (ii) owners shall subscribe to the system elected by charterers, provided such a system is approved by the International Group of P&I Clubs; (iii) charterers shall pay any fees incurred by owners in subscribing to such elected system; and (iv) charterers shall indemnify owners for any liabilities incurred arising from the use of the elected system, so long as such liability does not arise from owners' negligence[8].

The International Group of P&I Clubs have now "approved" three electronic trading systems namely BOLERO, EssDOCS and E-title. An "approved" system is one that is found to replicate the three legal characteristics of a paper bill set out above (namely as a receipts of the goods, document of title and the embodiment of the contract of carriage which incorporates the HR / HVR).

This means that the International Group of P&I Clubs will provide cover for any liabilities arising under carriage covered by these three electronic trading systems or any such other subsequently "approved" system, provided that such liability would also have arisen under a paper bill. The risks connected with the use of a non-approved electronic trading system are not covered.

The use of an electronic trading system does, however, lead to other risks from things such as hacking, systems collapse, e-theft and viruses, none of which are traditionally covered by P&I clubs and would need to be insured separately. In this regard, EssDOCS which is now used throughout 71 countries by over 3,300 companies has insurance cover of up to USD $20 million per electronic bill of lading for "eRisks" resulting from an electronic crime or electronic system failure.[9]

[7] The Bolero Electronic Bill of Lading (www.bolero.net/integration/rulebook).

[8] https://www.bimco.org/Chartering/Bills_of_Lading.aspx, UK P&I Club Circular October 2015.

[9] http://www.imco.edu.om/other-publications titled Port & Shipping News 02/16 11 – 17 Jan 2016

With the rise in usage of electronic trading systems, the recent judgment in *Glencore v MSC,*[10] now under appeal, provides a timely reminder that the release of cargo should only be made in accordance with the contract evidenced by the bill of lading, even where an electronic release system for cargo is being operated. In this instance cargo was released on presentation of a PIN, despite no provisions for this in the bill of lading, two of the released consignments of cargo were misappropriated and the carrier was held liable.

### 2.5 The way forward

With the International Group of P&I Clubs' approval of three electronic systems, the inclusion of an electronic bills of lading clause in BIMCO's latest NYPE form and the proliferation of the use of electronic trading systems throughout the wider shipping industry, it is clear that the use of electronic trading systems is increasing. Whilst there is no doubt that we can expect teething problems as the industry continues to adapt to such electronic trading systems, it is clear that the efficiencies are too great to be ignored. South African financial institutions have not come on board when it comes to this innovation. It is hoped that the South African Receiver of Revenue (SARS) through its Modernisation Project[11] will force this change and require shipping agents to submit electronic bills of landing and drive necessary legislative change. It is submitted that in light of the existing legislation recognising electronic data and the admissibility of such in courts, very little has to be done in this regard.

## 3 *MT798: developments in the corporate and bank space*

### 3.1 Introductory comments

An ongoing dilemma for treasurers and finance managers leveraging trade instruments such as letters of credit (LCs) is how to automate and streamline bank communication and integrate processes with internal systems. This is particularly complex bearing in mind the amount of documentation that is typically required to support a trade transaction, and the diversity found in the banks' front-end systems.

There have been two parallel developments in recent years to support more efficient trade processing. Internally, many companies have centralised and standardised their trade processing, which is often a vital first step in resolving the challenge of fragmented processes and formats within the business. On the banks' side it can be noted that for years a physical letter of credit had to be signed by an officer of the company and countersigned by the bank when it was delivered to the beneficiary. Mailed letters were then replaced by telex communications, fax and email. More recently, leading banks and vendors have invested considerably on the online front-end platforms to automate and streamline international trade, and support closer integration with customers' internal systems.[12]

[10] *Glencore v MSC* 2015 EWHC 1989 (Comm).

[11] In terms of Government Notice R814 dated 31 July 2009, SARS is legally mandated to enforce the use of electronic data interchange (EDI) for the submission of certain cargo and goods declarations and reports. EDI is essentially a "paperless" trading system. It involves the electronic transfer of data, by established message standards, from one computer application to another (www.sars.gov.za/ClientSegments/Customs-Excise/Processing/Assessment/Pages/Electronic-Data-Interchange).

[12] Case Study: Moving Swift Messaging up a Gear at Volvo via MT 798found on www.gtnews.com/articles/case-study-moving-swift-messaging-up-a-gear-at-volvo-via-mt-798.

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Despite the often considerable sophistication of these front-end solutions companies that work with multiple banks typically need to work with multiple platforms, maintain separate interfaces with their in-house systems, undertake separate approval processes and manage different security profiles. This results in fragmented processes which big corporates are trying to avoid by streamlining their own internal process, higher costs and operational risk which is a great inconvenience to MNC dealing with high trade volumes. This is the gap that Mt798 SWIFT for corporates is attempting to address.

### 3.2 Mt798 as a solution

The well-known bank-to-bank communication platform offered by SWIFT has created a platform for bank-to-corporate communication in recent years. Unlike traditional bank front-end systems, corporations can connect with multiple banking partners through a single channel.[13] MT798 offers corporates improved efficiency through integration with their ERP and simplified multi-bank access. It allows treasurers to consolidate all trade transactions and manage them under a single view.

This streamlines integration and communication, facilitates standardised processes and reduces operational risk. Furthermore, as a bank-neutral platform, corporations are less reliant on individual banking partners and can introduce new banks easily without the need for additional technology.

Although SWIFT was originally chosen by the largest multinational corporations that often had a very large number of banking partners, the spectrum of businesses adopting SWIFT has now expanded substantially, encouraged by growth of service bureaus, who provide SWIFT connectivity services without the need for the company to invest in these skills, and SWIFT's introduction of Alliance Lite, and Alliance Lite web-based solutions, that have further lowered the barriers to entry.[14]

In most cases, corporations have used SWIFT to exchange cash-related information such as urgent and bulk payments and bank account statements. In 2008 SWIFT introduced MT798, a new message type for trade-related messages, including import and export documentary credits, standby LCs and demand guarantees. The MT798 message is effectively an "envelope" into which all actions and information related to a transaction can be included and exchanged with the relevant banking partner, whether or not a corporation is the issuer or receiver of an LC or other trade instrument.[15]

Industry standards developed by international standardisation bodies trade-finance instruments such as UCP600, URDG758, ISP98, URC 522, URBPO and MT standards for L/Cs, Demand Guarantees, Collections as well as ISO 20022 standards offer a dependable legal and operational framework for market adoption of the MT798 standards.

### 3.3 MT798: slow adoption

Again this obvious benefit offered by SWIFT as an extension of the bank-to-bank MT message has not been widely adopted. Despite MT798 being launched in 2008, it was reported in the SWIFT report at SIBOS 2014 that MT798 was live with only

[13] https://www.swift.com/our-solutions/global.../trade-digitisation.

[14] http://www.treasury-management.com/article/4/276/2325/mt798-a-solution-for-trade-efficiency.html.

[15] www.treasury-management.com/article/4/276/2325/mt798-a-solution-for-trade-efficiency.html.

20 corporates and 30 banks.[16] It is reported that most banks that have developed their own front-end system do not see much benefit from enabling MT798 as they view MT798 to be opening the captured trade revenues removing the stickiness they have through their front end platform.[17] This view is regrettable and short-sighted and exposes banks to a situation where the corporates will find them irrelevant in light of the digitisation drive in the corporate space. It is submitted that the banks ought to look at this innovation with a different mind-set and jump on board to capture the opportunities that will arise from the corporates that are defining their own preferred means of communicating with the banks. Considering the impending wave of further digitisation, banks will be well advised to keep abreast with these developments and remain relevant.

## 4 *BPO: another trade digitisation effort*

### 4.1 Introductory comments

The bank payment obligation (BPO) is another recent digital innovation. It provides the benefits of a letter of credit (LC) in a digital multi-bank environment and offers working capital efficiencies and cost savings.

A BPO is a payment assurance instrument, which offers the possibility of confirming an open account payment obligation between banks, thus ensuring the viability of settlement.[18] BPO provides all the benefits of a letter of credit but in an automated environment, without the drawbacks of manual processing found in traditional trade finance. A BPO is no more than an irrevocable undertaking given by one bank to another that payment will be made on a specified date on the happening of a specified event. The "specified event" is evidenced by a "match" report generated by SWIFT's Trade Services Utility (or equivalent transaction matching application) using standard ISO 20022 messages. The use of the ISO 20022 messaging system means that banks globally are positioned to collaborate with one another without the need for establishing whole new systems of equivalent communication.[19]

The matching of data reflects events that have taken place in the physical supply chain so enabling pre- or post-shipment finance upon confirmed shipment orders or upon approved invoices respectively. Unlike the manual checking of documents, any vestige of subjectivity attached to data matching is removed – it either matches or it doesn't.

The credibility of the documentary credit as maintained and regulated by the ICC's *Uniform Customs & Practice for Documentary Credits* (UCP) has gained almost universal acceptance. Taking its cue from this legacy the Banking Commission of the International Chamber of Commerce (ICC) launched its *Uniform Rules for Bank Payment Obligation* (URBPO)[20] in 2013. URBPO has been the result of collaboration between SWIFT and the ICC to develop and adopt industry-wide standards that govern the handling of payment obligations between banks worldwide.

[16] www.swift.com/sites/default/files/resources/swift_oursolutions_paper_embracingdigital intradefinance, Boston Consulting Group Working Paper: Embracing Digital in Trade Finance.
[17] *supra.*
[18] *A Banking Commission Supply Chain Finance Project – SWIFT and ICC Collaborate on Enhanced Rules and Tools for Trade Finance* (icc.tobb.org.tr/docs/Bank%20Payment%20Obligation).
[19] (n 17).
[20] *Uniform Rules for Bank Payment Obligation* 750.

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### 4.2 Intended purpose of the BPO

As stated above the trade finance industry is witnessing a shift away from the use of traditional trade-finance instruments, such as letters of credit, towards open-account trading. Open-account transactions are reported to account for 90% of the world trade.[21] Although open-account trading offers many benefits attracting less banking fees, exporters are greatly exposed to payment risks as it offers no risk mitigation and limited financing opportunities depending on the creditworthiness of the parties. The trade risk is heightened for exporters where they have to offer extended payment terms to remain competitive. This is the gap that (BPO) was meant to close whilst aiding to digitise trade as financial decisions are made on movement of data not paper.

Essentially, the idea behind the BPO is to have a trade finance instrument that is less risky than open-account transactions and more automated than traditional letters of credit – one that combines the best of both worlds.

When compared to open account transactions, one of the main advantages of settling transactions using a BPO is payment assurance.

### 4.3 The BPO defined

The BPO is defined as an irrevocable undertaking given by one bank to another bank that payment will be made on a specified date following the successful electronic matching of trade data.[22] Therefore, the BPO ensures both the viability of settlement by open invoice and allows processing of trade data on an electronic basis.

While the BPO is not an electronic documentary credit (as it cannot replace the scope of risk protection of a letter of credit) the electronic matching of data requires a solid basis of trust between the trading partners and therefore offers enhanced risk mitigation, particularly as regards shipment and contract-performance risk.

Furthermore, the automatic data matching results in speedier and simplified processes in that the electronic trade data is exchanged via a platform, whilst shipping documents are sent directly from the seller instead of via the seller's bank to the buyer. This increased efficiency in turn reduces handling costs and improves working capital due to faster payment processes as well as confirmed due payments.

Other key benefits include the ability for exporters to finance their receivables. Sellers can benefit from pre- and post-shipment financing from their own bank based on an approved purchase order or invoice under a BPO, while buyers can negotiate extended payment terms and pricing conditions with their buyers or respective banks.

On the other hand, from the perspective of the banks, it enables the banks to accelerate trade financing processes, as well as increase visibility on transaction details in order to better support corporates along their supply chain with risk mitigation and financing transactions. Furthermore, the digital nature of BPOs also removes the administrative burden and operational risks associated with paper-based document examination. Finally it enables the exporter to raise pre- or post-shipment finance at significantly reduced rates since the export bank would take the BPO as the collateral for the financing.

[21] *ICC Global Trade Survey: 2015 Rethinking Trade and Finance*.

[22] *Uniform Rules for Bank Payment Obligation* 750

### 4.4 The BPO: market adoption

While the advantages of this trade finance instrument are well documented, there has not yet been widespread adoption of the BPO by banks and corporates alike. SWIFT issued a report on BPO's market adoption, stating that 56 banks are in the process of adopting the new instrument and of these banks only 17 are ready to go live and eight have serviced live BPOs[23]. On the corporate side, only 25 corporates are running live BPOs.

Several reasons have been touted for the slow take up of this product by banks and corporates. Firstly, there is still not sufficient awareness in the market of the BPO and its advantages. While 25 corporates are currently using the BPO, many more could benefit from the increased efficiency and enhanced competitiveness that the instrument offers. The survey conducted by JP Morgan indicated that that 61% of corporates interviewed were not aware of the product. In this regard banks have a key role to play in educating their corporate clients on the use of BPOs.[24]

In addition to market awareness, a major challenge for banks going live with the BPO is finding and on-boarding all of the parties involved in a BPO transaction. In order for a BPO transaction to run successfully, not only does a corporate client's trade partner first have to agree to settle a transaction using the BPO, but the trade partner's bank must also be BPO-ready. This inevitably adds a certain degree of complication to the process.

The other reported reason is that some banks may be hesitant to deploy the BPO because they are concerned about the technological investment required. However, this point is perhaps overplayed: the only real requirement is to have access to a matching engine (such as SWIFT's Trade Services Utility) to forward the trade data of the buyer or seller.

What is also holding back the widespread adoption of the BPO is the fact that some banks are still waiting for others to make the first move which is preventing the BPO from moving forward. Certainly, it will take time for wider market adoption when banks are waiting to take the plunge and corporates are still learning.

Lastly, and the reason I would argue is valid and requires the attention of the ICC, is that the URBPO only regulates the interbank space and it does not regulate the corporate to bank space or corporate to corporate space. This raises a number of legal questions on the instructing corporate in terms of its rights and obligations as covered under UCP600 in the case of an LC. The failure to address the relationships between corporates, and between banks and corporates, is a major inhibitor to corporate buy-in. In the absence of end-to-end rules covering corporates as well as banks, there is a need to try to standardise the agreements between corporates and banks, in order to provide a consistent product experience and boost the product uptake.

Nevertheless, the idea behind the BPO ought to be embraced by the trade and supply chain finance community as it promises a paperless financing solution that offers a measure of risk mitigation. There is a real danger that the BPO will be overtaken by events as more recent innovations in supply chain threatens to capture the imagination of trading companies and finance providers alike, rendering the BPO obsolete before it has gained any significant critical mass. The emergence of blockchain technology and its application to trade finance promises to do just that. This emerging trade-finance digitisation innovation is discussed below.

[23] https://www.swift.com.

[24] http://www.tfreview.com/blog/bank-payment-obligation-where-do-we-go-here.

## 5 *Blockchain and trade finance*

### 5.1 Introductory comments

At the outset it's important to state that blockchain is not going to be penicillin for all trade finance ills. It instead presents its own legal challenges which will not be addressed in this article. There will remain a need for the BPO for those clients wanting to mitigate against the payment risk but do not want to use LCs. Blockchain is set to step in and cover the rest of the open-account space. This is the next best thing in trade finance.

Bugeja urges that the current supply chain finance proposition is quite limited in scope, which suggests that there is a gap in the market for end-to-end SCF, triggered by events in the physical supply chain starting with the purchase order.[25] He states that most physical supply chains involve a minimum of three trading parties and each trading party in a supply chain, other than the final consumer, is both a buyer and a seller. If the parties are trading on open-account terms, the supply chain financing options available to them today are typically invoice based: seller-centric receivables finance and buyer-centric payables finance. Both solutions are underpinned by credit appetite on the buyer (the source of repayment) which may be enhanced with credit insurance if required. Banks today miss very obvious financing opportunities posed by the interlinked supply chain namely: (i) the physical supply chain; (ii) the financial supply chain; and (iii) the information supply chain.[26]

Events in the physical supply chain have financial consequences and each event generates data. Data from the physical supply chain drives financial interventions that address the financial consequences. Today, in the transactional trade finance world, this data is delivered in paper form. Blockchain promises to close this gap by making the end-to-end supply-chain data digitally available to value chain participants to make key decisions thereby enabling banks to extend their trade finance offering at every point in the supply chain.

### 5.2 Blockchain defined

Blockchain is a digital, distributed transaction ledger, with identical copies maintained on multiple computer systems controlled by different entities. Anyone participating in a blockchain can review the entries in it; users can update the blockchain only by consensus of a majority of participants. Once entered into a blockchain, information can never be erased. It contains an accurate and verifiable record of every transaction ever made. Blockchain, put simply, is a database holding unalterable transactional information supplied by users on the platforms. This distributed ledger technology came into the picture in early 2014 with bitcoin, and banks are now beginning to investigate its application in trade finance. A number of banks are already in partnership with a number of Fintech companies to develop common platforms for trade finance. The blockchain has two main variants namely permissionless or public blockchain and permissioned or private blockchain.

### 5.3 Permissionless (public) ledgers

What characterizes the permissionless ledgers is that there is no gating or authorizing process to enrol into the transactions scheme; they are in theory a public ledger.

[25] *Bank Payment Obligations: Where Do We Go from Here (*http://www.tfreview.com/blog/bank-payment-obligation-where-do-we-go-here).

[26] (n 24).

Anyone is free to download the software, submit messages for processing and/or be involved in the process of authentication, verification and reaching consensus.[27]

Considering the data legislations as such as the Protection of Private Information Act 4 of 2013, KYC, AML and various sanctions such as US OFAC, EU and UK sanctions restrictions, it is argued that this variant of Blockchain is not likely to be adopted in the financial sector.

### 5.4 Permissioned (private) ledger

A blockchain is permissioned where its participants are pre-selected or subject to gated entry on satisfaction of certain requirements (this could include, for example, a requirement that a participant must first satisfy KYC and AML requirements) or on approval by an administrator of the blockchain. A permissioned blockchain may use a consensus protocol for determining what the current state of a blockchain should be, or it may use an administrator or sub-group of participants to do so.[28]

In a trade transaction one can imagine a system run by a consortium of financial institutions, being banks that have a relationship with each other and KYC(ed) and where the shipping agents, shipping liners and port authorities have to validate the transaction at each stage.

Permissioned ledgers replicate the high degree of transparency and accountability in traditional banking systems. Banks are given an important task to fulfil. In light of these features it is submitted that this is the variant that could potentially see the light of day in the financial sector.

### 5.5 Blockchain: a move to trade digitisation

Distributed ledgers can ensure full transparency of the value chain, reduced error rates and credit risk, lower costs, improve convenience, and provide a level playing field for all participants. This in turn can help corporates improve liquidity and working capital, upgrade the reconciliation process, and provide additional financing opportunities, while allowing banks to meet customer expectations, modernize IT systems, enable the development of new products, and avoid disintermediation.

### 5.6 Blockchain as a fraud-prevention mechanism

Blockchain promises to do away with paper invoices and the fraud that accompanies them. The risk posed by fraud in invoice financing has prompted banks to start exploring distributed-ledger technology to create visibility of invoices already financed by other banks. Lenders typically don't publish their losses from trade fraud, though almost 20 percent of banks in a 2014 survey by the International Chamber of Commerce reported an increase in fraud allegations.[29]

Standard Chartered Plc, which lost almost USD200 million from a fraud in the Chinese Qingdao case in 2014, has teamed up with DBS Group Holdings Ltd to develop an electronic ledger for trade invoices, and some other banks are looking at blockchain for trade finance and other banking applications.[30]

[27] Norton Rose Fulbright *Unlocking the Blockchain: A Global Legal and Regulatory Guide* 20.
[28] (n 26).
[29] ICC *Rethinking Trade & Finance Report* (2015) 157.
[30] www.globaltimes.cn/content/, washpost.bloomberg.com/Story, www.clydeco.com/insight/article/mercuria-v-citi-high-court-rules-on-qingdao-warehouse-financing-case.

In the Qingdao case, companies controlled by a Chinese-born Singaporean businessman are alleged to have used invoices for the same metal stockpiles several times to defraud banks out of hundreds of millions of dollars. Standard Chartered wrote down USD 200 million in commodity assets in 2014 because of the incident. In another example, a trans-Atlantic fraud conspiracy that used fictitious purchase orders and fake invoices to acquire loans for metal shipments was estimated in 2008 to have cost banks including JP Morgan Chase & Co close to USD700 million.[31]

Because there is no common platform for banks to screen transactions financed by other banks due to confidentiality concerns, there is a possibility that customers may capitalize on this information-sharing gap to obtain financing from multiple banks using the same invoice. By going digital, banks will also have increased visibility over the end-to-end physical and financial supply chain. This would give the banks the opportunity to pull out of transactions early on when the invoices are not verified by the issuers and where other banks have provided finance relating to the same invoice.

For example, a bank may be much more comfortable to provide pre-shipment financing if it can see the creation and acceptance of a purchase order. A next step could be that banks extend trade-finance services to customers in locations where the bank does not have a physical presence.

### 5.7 Blockchain driving processing efficiencies

One of the key attributes of blockchain is that all parties in the values chain from seller to the buyer's shipping agent and port authorities can view and validate transactions instantly as soon as the transaction get to then in their block. The process is not held up by movement of documents. In this way banks are able to rely on one source to track the movement of goods and the transfer of ownership in order to offer trade financing at the point where the clients would require it instead of offering solutions that consume the bank's capital before the goods are even shipped. As stated above this digital solution is at its infancy a number of Fintech companies and banks are exploring various ways to implement it in trade finance. Financial institutions are warned to stay abreast with its development and actively participate in the development of this earth breaking innovation.

## 6 *Conclusion*

This growing use of technology creates a shift in the balance of power. Digitisation is not just about elimination of paper. It breaks the hold of banks around client access. If a bank is SWIFT798-capable the corporate can interact with that bank without restriction to interact with the bank through bank-owned electronic platforms. Challenges are that banks have been internally focused developing yesterday's technology for tomorrow. Banks have spent a considerable amount of money developing bank owned front-end systems which restrict the use of such front end to one bank. This is not the direction the corporates are taking. Unfortunately the banks might find these platforms absolute if they do not catch up with the pace of development in their clients' space.

With regards to BPO the solution is quite solid; the fault is with the marketing as evidence shows that banks have not educated their clients about this solution. It

[31] *supra.*

is inconceivable that corporates that are driving digitisation will not welcome this development. This is in the banks court. Banks ought to actively sell the benefits of this solution to their clients, particularly those that are expanding their sales reach to new markets with uncertain payment risks yet wanting to remain competitive. Bank-to-bank marketing is also critical. To have critical mass on TSU and BPO is possible where both the importer and exporter bank are on the network and TSU enabled.

On the down side, the fact that URBPO (the ICC rules governing the operating of the BPO) only covers the roles, rights and responsibilities of the issuing/obligor bank and the recipient bank, and excludes the corporate trading parties, is certainly unhelpful when it comes to positioning the BPO as a transactional trade-finance product. This should be addressed in due course through an update to URBPO but this is not a quick solution.

On the most promising digitisation innovation, namely blockchain: if banks are not already thinking about how they are going to prepare themselves to come on board of this wave of technological change they better do so now. The majority of financial institutions (61%) surveyed by J.P. Morgan stated that they are either starting to formulate a strategy or already have a strategy in place around digitisation, because clients worldwide are demanding from their banking partners the support they need to keep up in today's fragmented trade environment.

Digitisation is not a goal in or of itself. It is a solution that can facilitate trade, and as more and more processes along the supply chain become automated, the financial industry should – and must – do more to drive its adoption. Digitisation is a strategic shift by corporates to which banks must respond. Large corporates will eventually deal only with banks that are digitised. This requires a paradigm shift in behaviour for banks, but the impact will be huge.

While there are hurdles to overcome, from investment budget to technology limitations, operating risk and compliance issues, digitisation offers a compelling proposition to banks as a way to reduce costs, enhance risk management and meet client expectations. Digitising the trade finance process has real, tangible benefits. This is not a pie-in-the-sky initiative, but a real sea change that translates directly to greater efficiency, improved working capital for clients, decreased risk along the global supply chain, and better margins and reduced costs for the institutions that finance global trade.

Regulators and Receivers of Revenue also have to follow suit. This is an industry-wide movement, and one which makes collaboration necessary. To move forward, priority needs to be given to the development of common technology platforms, a framework of standards for the new environment, and training and sensitisation of clients. In a sector which has traditionally been slow to embrace change, this is one of those rare occasions where a new direction can truly be taken for the benefit of all.

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# The Ombudsman for Banking Services: mandate, jurisdiction, interesting case studies and its place within the twin peaks model

NEROSHA MASETI*

## 1 *Introduction*

The origin of the word "ombudsman" can be traced back to Scandinavia.[1] The term is an English translation of the Swedish word "umbuds man" from the Old Norse word "umbodhsmadhr" meaning deputy, agent or plenipotentiary.[2] In recent years the institution has become known as an institution that provides access to justice for many people who would otherwise find it difficult to enforce their rights. It is recognised as an institution that provides fast, cheaper and less formal resolution of complaints than our courts.

A number of industry specific ombudsmen have been established in the South African financial sector. The National Credit Act[3] (NCA) and The Consumer Protection Act[4] (CPA) recognises two kinds of ombud in the definition of an ombud with jurisdiction.[5] These are statutory ombuds which are appointed for an industry by statute, such as the Financial Advisory and Intermediary Services Act[6] (FAIS) and ombuds for financial institutions as defined in the Financial Services Ombud Schemes Act[7] (FSOS). The Ombudsman for Banking Services (OBS) is a scheme recognised under section 11 of the FSOS and has statutory jurisdiction to deal with matters arising from the NCA.

The OBS was first established in 1997 and briefly operated under the name Office of the Banking Adjudicator. It is a section 21 (non-profit) company[8] with a board comprising of four independent directors that are not associated with the banking industry, three directors that are representatives of the banking sector and an independent chairperson. The composition of the board assists in assuring that the scheme is and remains independent.

The procedures adopted by the OBS for investigating a complaint are relatively informal and inquisitorial. The OBS's procedures seek to reflect the essential principles of the Constitution of the Republic of South Africa[9] and natural justice.

* LLB (Natal). LLM (UJ). Attorney of the high court of South Africa. Adjudicator at the Ombudsman for Banking Services for the past 10 years. Currently the Acting Manager, Adjudications Department.

1 Melville "Has ombudsmania reached South Africa? The burgeoning role of ombudsmen in commercial dispute resolution" 2010 *SA Merc LJ* 50.

2 Ibid.

3 Act 34 of 2005.

4 Act 68 of 2008.

5 Worker "Consumer protection and alternative dispute resolution" 2016 *SA Merc LJ* 21 48.

6 Act 37 of 2002.

7 Act 37 of 2004.

8 s 21 of the Companies Act 1973.

9 Act 108 of 1996.



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The complainant and the bank are given a reasonable opportunity to present their case before any finding or decision is made by the OBS. The reasoning and material relied on in reaching any decision is disclosed to the parties and the affected party is given the opportunity to respond to that material or reasoning.

Once the facts of a particular matter have been assessed, the OBS can make an assessment, recommendation (provisional or final) or determination based on its Terms of Reference, the Code of Banking Practice, relevant law, international best practice and equity. The OBS can also mediate a mutually agreeable settlement of the dispute between the bank and the customer.

This contribution will provide some insight on the role of the OBS in alternative dispute resolution. It will further provide clarity on its jurisdiction, which will be illustrated by some interesting case studies and finally it will provide some insight on its future within the twin peaks model of financial regulation.

## 2 *Mandate*

It is important to understand the mandate of the OBS in order to understand its rulings.

The role and mandate of the OBS is detailed in its Terms of Reference. The OBS is tasked with adjudicating matters between banks and banking customers in a fair, quick, confidential and effective dispute resolution process that is free of charge.[10]

The OBS is an alternative dispute resolution body.[11] Its strength lies in being able to provide a speedy, cost effective and less formal resolution of complaints than our courts.[12]

The alternative dispute resolution process is a voluntary process which is based on agreement. Banks are bound by the OBS's Terms of Reference by virtue of their membership of the Banking Association of South Africa, and banking customers who lodge a claim with the OBS have to agree to the Terms of Reference.

While the OBS provides an alternative to taking a matter to court, it is not a court. In matters involving complex issues, where legal certainty is required and where the testimony of witnesses is required (examination and cross examination of expert witnesses) a court is likely to be a more appropriate forum to resolve the dispute.

In a recent test case, the issue that was referred by the OBS to a judge for consideration was whether a beneficiary bank owed a legal duty to a non-customer to prevent pure economical loss in the context of phishing. The beneficiary bank in question disputed the Ombudsman's recommendation to compensate the non-customer for loss that he suffered as a result of the bank's alleged failure to open the account properly (verification of the prospective customer) on the basis that there was no contract between the non-customer and the beneficiary bank. Due to insufficient evidence the judge was unable to make a finding against the beneficiary bank. It

[10] Terms of Reference of the Ombudsman for Banking Services 2. See also http://www.obssa.co.za/ (accessed on 28 September 2016).

[11] See Finmark Trust Report *Landscape for Consumer Recourse in South Africa's Financial Services Sector* (2007) 6. Alternative dispute resolution is described as: "a variety of methods for resolving disputes between parties without traditional legal representation or litigation. Instead, ADR involves a third party – a neutral individual – who works with both parties to the dispute to resolve their differences. ADR is conducted in a more businesslike manner and is less adversarial than litigation".

[12] Melville (n 1) 55. In the Ombudsman for Banking Services Annual Report (2013) it was noted that R23 million had been recovered for consumers in 2013, which was a notable increase from 2009 and 2012. Clive Pillay, the current Ombudsman, stated that not one of the consumers which the OBS had assisted would have had the means to take their disputes to civil courts.

was the recommendation of the judge that the Ombudsman should recommend to its shareholders the institution of a test case to court to determine whether a duty rests on a beneficiary bank towards the victim of a phishing or other fraud to receive payments with reasonable care, and what reasonable care in the circumstances entails.

This is an example of a case that was found to be more suited to a court of law, due to the legal certainty that was required and due to the need for the examination and cross examination of expert testimony.

### 3 *Jurisdiction*

The OBS shall at the Ombudsman's sole discretion, determine whether a complaint falls within its jurisdiction.[13] The jurisdiction of the OBS is detailed in clause 3 and clause 4 of its Terms of Reference.

#### 3.1 Disputes or complaints that may be considered by the OBS

- The OBS Terms of Reference provide that in order to bring a complaint against a bank you must be a customer of the bank.[14] In the test case that was referred to a judge, one of the grounds of objections raised by the beneficiary bank was that the OBS did not have the jurisdiction to consider the complaint as the complainant was not a customer of the beneficiary bank. After considering the Terms of Reference it was the judge's recommendation that the Terms of Reference should be reviewed to provide for redress not only against the bank of the customer complained of but also against other banks involved, directly or indirectly and whether or not a complaint is made against them. The OBS is presently in the process of changing its Terms of Reference in accordance with the judge's recommendation.
- The OBS has jurisdiction to deal with complaints which concern a bank's own products or services or advice that is given by a bank's own staff either in relation to the bank's own products or to the products of other institutions.[15]
- The OBS investigates maladministration on the part of the bank which leads to loss, distress or inconvenience.
- If the complaint is brought by an individual, the claim cannot exceed R2 million. If the complaint is brought by a small business, partnership, association trust or close corporation, its annual turnover cannot exceed R10 million.
- The complainant must first have raised the complaint with the bank's dispute resolution department unsuccessfully.

#### 3.2 Disputes or complaints that may not be considered by the OBS

- Disputes or complaints falling within the jurisdiction of a statutory Ombud as defined by the enabling legislation.
- A dispute or complaint that is based on the same event and/or fact as any matter which is, was or becomes, the subject of any proceedings in any court tribunal, regulator or other independent dispute resolving body, unless proceedings were instituted by the bank and the OBS has considered it appropriate to intervene and is not prohibited under law from so intervening.

[13] See (n 10) 3.
[14] See (n 10) 5.
[15] See (n 10) 6.

- A dispute or complaint that is under consideration by a legal practitioner, whether or not with a view to instituting legal proceedings, unless the OBS determines that the involvement of a legal practitioner is appropriate in the circumstances.
- A dispute or complaint that would be appropriately dealt with by a court of law or through any other dispute resolution process.
- A dispute or complaint that relates to an act or omission which occurred more than three years prior to the date when the complaint was lodged with the Ombudsman or a claim that has become prescribed by law. The period of three years commences on the date on which the complainant became aware or ought reasonably to have become aware of such occurrence, whichever occurs first.

### 3.3 Equity jurisdiction

The OBS when making a finding, takes into consideration all the rules and the law that has bearing on the particular case.[16] However, if after applying the rules and the law it is found that the outcome is unfair, the OBS may rely on fairness in order to do justice between the parties.[17] The OBS therefore has the right to apply considerations of equity if the application of the law would lead to an unfair result.[18]

Shelton states: "[a]n ombudsperson should be guided by the following principles: objectivity, independence, accessibility, confidentiality and justice; justice is pre-eminent (own emphasis)".[19] When considering a complaint, the OBS is guided by a concern for and commitment to justice.

A consideration of justice involves carefully balancing individual interests with the consideration of the good of the larger community. It also requires an understanding of power, the use and misuse of power and authority as well as the recognition of the need for access to power.[20]

Essentially, an important consideration in demarcating the OBS's powers is its jurisdiction to look beyond the black letter of the law and take into account considerations of fairness and equity in its findings.

## 4 *Case studies*

### 4.1 Case study 1[21]

The complainant disputed the linking of her bond account to her ex-husband's transactional account and wanted the bank to reimburse the amount withdrawn by him without her knowledge and consent. The complainant advised that her ex-husband had arranged for her bond account to be transferred to another bank. As she did not qualify for the full bond, her ex-husband stood as surety for the loan.

Four years later, they were divorced, at which point it came to her attention that since the inception of the bond, he had withdrawn a total sum of R1, 6 million from

[16] According to the Terms of Reference, the criteria used to resolve disputes are: the law, especially FSOS and the NCA; applicable industry codes or guidelines; good banking practice; banking practice in other jurisdictions; and fairness in all circumstances.

[17] S 10 (e) (iv) of the FSOS Act 37 of 2004 requires all ombuds in the financial services sector to apply principles of equity in resolving complaints where appropriate. See also (n 5) 33 and Millard "Bespoke justice? On financial ombudsmen, rules and principles" 2011 *De Jure* 232.

[18] See also Galgut "Litigation can be cost free and equitable considerations can replace the law" *Advocate* 24. S 10 (g) of the FSOS Act 37 of 2004 provides that no ombudsman scheme will be recognised or entitled to operate unless it has an equity jurisdiction.

[19] "Justice as basis of equity and fairness in ombudsman practice" 2011 *JIOA* 18.

[20] See (n 19) 19.

[21] *Ombudsman for Banking Services Annual Report* (2015) 29.

the account. The complainant advised that she did not attempt to resolve the issue as part of the divorce proceeding on the advice of her attorney. The complainant wanted the bank to reimburse the funds with interest and to compensate her with R50 000.00 for distress and inconvenience.

The bank's response was that the complainant, according to a telephone conversation that it had on record between the complainant and a bank consultant just after the account had been opened, was aware and had consented to the linking of the accounts. The complainant refuted this. After listening to the call recording, it was clear to the OBS that the complainant was informed that her bond account would be linked to her ex-husband's card number.

The complainant further complained that she had not received bond statements since the bond's inception and had followed up on this in 2013. It was concluded that it was unreasonable that it took three years for the complainant to follow up on her statements. It was further concluded that her claim for the disputed withdrawals before 2013 had prescribed.

It was subsequently confirmed by the bank that all deposits paid into the complainant's bond account were from the ex-husband's cheque account. It was found that whilst he had made withdrawals from the bond account totalling a sum of R1,59 million, he also made lump sum deposits into the said bond account totalling a sum of R1,567 million rand. There was a deficit of R23 000.00. The bank offered to refund the complainant with the amount of R23 000.00, an offer which the OBS found fair and reasonable.

The principle that emerges from this case study is that to claim damages against a bank, you must be able to prove a loss.

### 4.2 Case study 2[22]

The complainant's family paid for a trip for her and her sister to Mauritius as a gift for her 60th birthday. Prior to the trip the complainant visited her bank to ascertain whether she would be able to use her bank card overseas. The bank consultant that assisted her, confirmed that her card could be used overseas.

The family gave her R5000.00 in spending money, which was deposited into her account. Whilst in Mauritius she discovered that her card did not work. When she contacted the bank, she was informed that her particular type of card would not work overseas and that she was given the incorrect advice by the bank consultant.

The complainant had to borrow money from other tourists. On her return, she lodged a dispute with the bank and claimed the value of the flights and accommodation as compensation for the distress and inconvenience caused. The bank offered an amount of R5000.00.

She refuted the bank's offer and lodged a claim with the OBS. It was noted that the accommodation and food was paid in advance, hence the complainant was able to stay for the full holiday. It was acknowledged however that not having access to her funds due to the bank's error certainly caused her distress and inconvenience.

Whilst a reimbursement of the cost of the entire trip was unfounded, it was recommended to the bank that it reinstate its offer of R5000.00, as the OBS found the offer to be fair and reasonable. The bank agreed.

The principle that emerges from this case study is that banks must ensure that they provide the correct information on their products.

[22] See (n 21) 32.

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### 4.3 Case study 3[23]

The complainant contacted the bank's fraud department and informed the bank consultant that a SIM-swap was done on his cell phone and he was concerned about fraud. He further advised her that he was unable to log into his account to confirm whether any fraudulent transactions had already occurred. As a SIM-swap was done he was unable to receive any notifications of transactions.

After listening to a recording of the call, the OBS concluded that the consultant that assisted the complainant ought to have reasonably confirmed with the complainant whether the last few transactions on his account were authorized by him. Had she done so, she would have been alerted to the fraudulent transactions and would have contacted the beneficiary bank timeously in order to prevent the loss. The beneficiary bank confirmed that the transactions on the beneficiary account had occurred after the customer's bank had been informed of the fraud.

It was concluded that it was not sufficient that the consultant stopped the complainant's account after she received the call from the complainant, she ought to have gone a step further and ought to have confirmed with the complainant whether he authorized the most recent transactions.

As the consultant was in a position to prevent the customer's loss and failed to do so, it was recommended by the OBS that the bank reimburse the amounts withdrawn by the beneficiary after the complainant had notified the bank about the fraud. The bank agreed with the OBS's recommendation.

The principle that emerges from this case study is that a bank can be expected to mitigate a customer's loss after fraud has been reported to the bank.

### 4.4 Case study 4[24]

The complainant disclosed his username and password to a bank employee, to enable the employee to make legitimate transfers and payments on his behalf. The employee then stole thousands of Rands from his account over five months. The complainant lodged a claim against the bank for his loss.

The bank submitted that it is a customer's responsibility to keep all account access information confidential. The bank instituted disciplinary procedures against the staff member.

The OBS took into consideration that the banks constantly educate customers to take reasonable steps to keep their card, PIN, password and other unique means of personal identification secret, safe and secure and never to disclose a PIN or password to anybody, whether family, friend or seemingly trustworthy bank employee. Customers accept this responsibility in the terms and conditions when they open a bank account.

It was concluded that the bank was not vicariously liable in this instance as the employee was not acting in the scope of his employment but was promoting his own interests.

The principle that emerges from this case is that confidential banking details must only be known by the account holder, and that the customer bears the responsibility of ensuring that this is the case.

[23] See (n 21) 33.
[24] See (n 21) 34.

### 5 *Twin peaks*

The Twin Peaks model of financial sector regulation will see the creation of two regulators, one to deal with financial stability, being the prudential regulator which will be housed in the South African Reserve Bank, and the other to deal with market conduct which will be the responsibility of the Financial Services Board which will be transformed into the Financial Sector Conduct Authority.[25]

The legislature has published the Financial Sector Regulation Bill[26] for public comment. This is the first of a number of bills which are being introduced to give effect to the government's intention to implement a "twin peaks" model of financial regulation in South Africa.

The objectives of the implementation of the twin peaks model is to strengthen our approach to consumer protection and market conduct in financial services and to make the financial sector safer and more stable in South Africa.[27]

In addition to the creation of the two regulators, the Financial Sector Regulation Bill also strengthens the ombud schemes. Chapter 14 of the Bill deals with Ombuds. After a consideration of a number of models for the ombuds, there was pressure to introduce a single structure with a chief statutory (super) ombud, who would then appoint sectoral ombuds to deal with specific areas. The wording of the previous draft makes references to "Ombud Regulatory Council" and "Chief Ombud". If this draft was accepted as a final draft this would have meant that the voluntary ombuds would have been abolished as all ombuds would have been appointed in terms of legislation.

The latest draft of the bill however, has removed references to "Ombud Regulatory Council" and "Chief Ombud" and replaced these terms with "Ombud Council" and "Ombud Council Director". As it presently stands, therefore, after consultation with the FSOS Council, existing ombuds and other stakeholders it was decided that the present model, which mainly relies on voluntary schemes will be retained as it has been proved to be functioning effectively.

Factors that strongly support the retention of the present model of ombuds is the fact that voluntary ombuds, such as the OBS, has obtained the necessary buy-in from its members and is cost-effective. Moreover, the voluntary ombuds rarely have to issue determinations or recommendations as their findings are generally accepted by their members early in the process.[28] Self-regulation has proved to be effective through voluntary ombud schemes.

The intention is to broaden the role of the FSOS Council, for it to play a far more powerful and stricter role. In the latest draft of the bill there is a move towards ensuring that there is consistency and uniformity in the processes adopted by the respective ombuds offices to ensure easier accessibility by consumers.

[25] See https://www.fsb.co.za/Pages/Home.aspx (accessed on the 19 September 2016). See also (n 5) 41.
[26] See http://www.treasury.gov.za/twinpeaks/Financial.pdf (accessed on the 28 September 2016).
[27] See (n 23).
[28] In the *Annual Report* for 2015 (n 21) the Ombudsman, Clive Pillay, confirmed that no provisional or final recommendations were done for the year.

## 6 *Conclusion*

Providing consumers with rights in law has little meaning if they cannot achieve quick and effective redress and if those rights are not effectively enforced.[29]

The OBS provides quick and effective redress to banking customers, thereby providing access to justice. At the same time it remains an independent body that strives to act fairly at all times when adjudicating disputes between the banks and their customers.

The Ombudsman, Clive Pillay, stated in the OBS Annual Report for 2015 that the OBS is one of the long-established and most procedurally-advanced ombuds offices on the continent. He goes on to state that as a new wave of South Africans become more aware of their rights and are gaining confidence in taking on institutions when they feel unfairly treated, he is confident that the OBS will remain important.[30]

Whilst the future of the OBS under the twin peaks model will only be certain once the final draft of the Financial Sector Regulation Bill is passed, one thing is clear: as evident from its Annual Report for 2015, the OBS effectively delivers on its mandate and has become a key player in alternative dispute resolution in the banking sector.

[29] Department of Trade and Industry "Fifth Draft Green Paper on the Consumer Policy Framework" par 4.1, available at http://www.gov.za/documents/consumer-policy-framework-green-paper-draft (accessed on the 22 September 2016).

[30] (n 21) 9.

# Value-added tax on financial services

THABO LEGWAILA*

> "Not only is the VAT a fairly simple tax, but it is also probably the most popular tax in the world today." *(Mark Bloomfield and Margo Thorning)*
>
> "The concept of value added is not clearcut or easily defined...On the whole, the value-added tax is not nearly as simple a levy as is sometimes argued." (*John F Due*).**

## 1 *Introduction*

Value-added tax (VAT) is a tax levied on the value added by each vendor in the production or distribution chain and is imposed each time a taxable supply of goods or services takes place. It is levied on the supply of goods and services by a vendor of goods or services in the course or furtherance of any enterprise carried on by him.[1] In addition, in order to create a level commercial ground between locally supplied goods and services section 7(1)(b) and (c) respectively impose VAT on the importation of any goods into South Africa as well as on the supply of any imported services by any person into South Africa.

The general charging provision in the South African Value-added Tax Act 89 of 1991 ("VAT Act") provides for the levying of VAT on the supply by any vendor of goods or services supplied by him in the course of furtherance of any enterprise carried on by him. Various definitions are paramount to the functioning of the VAT system. They are briefly the following:

- Enterprise: the general definition of enterprise is in relation to a vendor and means any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club.[2] Enterprise requires continuity.[3] Thus, an isolated transaction or transactions do not qualify as conducting an enterprise for VAT purposes.[4]
- Input tax is a tax payable by a supplier on the supply of goods and services made by that supplier to the vendor.[5]

* Professor of Law, University of Johannesburg.

** Both quotes taken from Williams "Value-Added Tax" in Thuronyi (ed) *Tax Law Design and Drafting* (2002) 164.

1 s 7(1) of the VAT Act.

2 See s 1: definition of "enterprise" in the VAT Act.

3 See Van Zyl "The value added tax implications of illegal transactions" 2014 *PELJ* 320 321 – 322.

4 In the New Zealand case N27 (1991) 13 NZTC 3 299 the New Zealand Taxation Review has interpreted the word "continously" to mean that the activity has not ceased in a permanent sense or has not been interrupted in a significant way.

5 See s 1: definition of "input tax" in the VAT Act.



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- Goods: means “corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity”.[6]
- Output tax is a tax charged by a vendor in respect of a supply of goods and services by that vendor.[7]
- Services: means anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card.[8]
- Supply: the ordinary meaning of supply means to provide, or make available. However the VAT Act expands this definition to cover performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected. The definition states that any derivative of “supply” shall be construed accordingly.[9]

### 2 *Rates*

The VAT Act provides for two types of supplies, namely taxable supplies and exempt supplies. Taxable supplies are subject to two different rates, the standard rate of 14% as well as the zero rate for those supplies that are specifically zero rated in terms of the Act.

What differentiates exempt supplies from zero-rated supplies is that when the supply of exempt goods or services is made, no VAT is chargeable. The supplier is in the same position as a consumer of the goods or services, and can therefore not claim any input tax incurred on the purchases relating to that supply. According to De Koker and Kruger,[10]

> “The effect of making exempt supplies is exactly the same as if the supplier concerned were either a private individual, that is, not carrying on an enterprise, or an enterprise that makes supplies of a value less than the registration threshold and is not registered. Consequently, a person making only exempt supplies
>
> - Does not have to register and in fact cannot register as a vendor;
> - Cannot charge VAT on the supplies he makes;
> - Is not entitled to any input tax deductions whatsoever.”

Williams summarises the effect of the exempt supply as follows:[11]

> “It is often assumed that “exemption” results in the reduction of the VAT burden on a supply. This is true if the person supplied is a consumer and is not receiving the supply as part of a business. It is not true if the person supplied is a taxable person. Exemption of a supply to a business results in an *increase* in the burden of VAT on the supply. The reason for this is that the person running the business can offset the VAT against the VAT charged by the business, so claiming a full rebate for any VAT. The person making the exempt supply will probably have had

[6] This definition excludes money; any right under a mortgage bond or pledge of any such thing or fixed property; and any stamp, form or card which has a money value and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector’s piece or investment article.

[7] See s 1: definition of “goods” in the VAT Act.

[8] See s 1: definition of “services” in the VAT Act.

[9] See s 1: definition of “supply” in the VAT Act.

[10] De Koker and Kruger *Value-Added Tax in South Africa* (2011) 6-2.

[11] Williams “Value-Added Tax” in Thuronyi (ed) *Tax Law Design and Drafting* (2002) 164 203-203.

> to pay VAT on some part of the supplies made to it and will therefore have to pass some VAT on to the business as part of its price. It is this VAT that can be recovered if the supply is subject to tax, but that cannot be recovered if it is exempt."

On the other hand, a supplier of zero-rated supplies charges VAT on his supplies at a rate of zero and is entitled to claim an input tax deduction for his allowable inputs.[12] The outcome is that no VAT is incurred by the supplier and technically by the consumer. Where a person makes taxable and exempt supplies, such person is entitled to deduct input tax incurred only to the extent that the input tax relates to the taxable supplies made by him.

### 3 *Registration*

The VAT Act requires that every person who carries on any enterprise and is not registered becomes liable to be registered in the following two circumstances: Firstly, if the total value of taxable supplies made by that person in the course of carrying on all enterprises has exceeded R1 million in any twelve month period. That person is liable to register at the end of the month that such supplies exceed the R1 million. Secondly, if the person is to make contractual obligations in writing that would result in that person receiving more than R1 million in the period of twelve months the person is required to register at the beginning of the month that such determination is made.[13] The registration requirement is subject to a proviso that excludes events that are not of a continuous nature.[14]

Once a person registers for VAT he becomes a vendor for VAT purposes. However, the VAT Act further defines a vendor as a person who is required to register, ie a person whose supplies exceed the R1 million in any twelve month period or who is to make contractual obligations in writing that would result in that person receiving more than R1 million in the period of twelve months. A variation of the South African registration requirement is found in Ghana. In 2015 banks were required to register and charge VAT on the qualifying fees on financial services. The Ghana Revenue Authority indicated during a seminar held three months after the implementation that banks should register for VAT and if they fail to they will be registered and notified accordingly.[15]

The New Zealand Goods and Services Tax Act 1985 defines a registered person as a person who is registered or is liable to be registered under this Act, and such person is liable to charge goods and services tax on the supply of goods and services in New Zealand in the course or furtherance of a taxable activity carried on by that person.[16]

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12 De Koker and Kruger (n 10) 2-3.

13 s 23(1); De Koker and Kruger (n 10) 12-2.

14 The proviso states that the total value of the taxable supplies of the vendor within the period of 12 months referred to in paragraph (*a*) or the period of 12 months referred to in paragraph (*b*) shall not be deemed to have exceeded or be likely to exceed the amount contemplated in paragraph (*a*), where the Commissioner is satisfied that the said total value will exceed or is likely to exceed such amount solely as a consequence of—

(i) any cessation of, or any substantial and permanent reduction in the size or scale of, any enterprise carried on by that person; or

(ii) the replacement of any plant or other capital asset used in any enterprise carried on by that person; or

(iii) abnormal circumstances of a temporary nature.

15 See PWC "VAT on Financial services" accessible on http://www.pwc.co.za/en/assets/pdf/on-point-vat-on-financial-services-3rd-edition.pdf (28 September 2016).

16 s 2(1) read with section 8(1) of the New Zealand Goods and Services Act 1985.

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South African banks are therefore required to register for VAT if their taxable supplies, ie fees, commissions and similar supplies exceed, or are projected to exceed R1million in a twelve month period. A voluntary registration regime exists for persons whose taxable supplies exceeded or is expected to exceed R50 000 over a twelve month period.[17]

### 4 *Exempt supplies – financial services*

The Act specifically provides for exemption of certain supplies. The first listed supply is that of financial services. Internationally financial services are generally exempt to avoid problems of complex administration, for example, where it is difficult to identify the value added within a transaction. While the financial service should be exempted from VAT, in principle, any fee or charge for a financial service should be liable to VAT.

According to Williams the "difficulty is in identifying that charge separately from the other elements that are included when determining levels of payments of interest or fees. Those other elements include the real cost of the capital involved, the risk to the lender of undertaking the transaction, and the inflation rate operative during the transaction."[18]

Financial services are defined in section 1 as activities that are deemed by section 2 to be financial services. Section 2 on the other hand defines financial services as follows:

> "Financial services.—(1) For the purposes of this Act, the following activities shall be deemed to be financial services:
>
> (a) the exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise);
>
> (b) the issue, payment, collection or transfer of ownership of a cheque or letter of credit;
>
> (c) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security;
>
> (d) the issue, allotment or transfer of ownership of an equity security or a participatory security;
>
> (f) the provision by any person of credit under an agreement by which money or money's worth is provided by that person to another person who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth;…
>
> (i) the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance in respect of any such policy: Provided that such an activity shall not be deemed to be a financial service to the extent that it includes the management of a superannuation scheme;
>
> (j) the provision, or transfer of ownership, of an interest in a superannuation scheme;
>
> (k) the buying or selling of any derivative or the granting of an option: Provided that where a supply of the underlying goods or services takes place, that supply shall be deemed to be a separate supply of goods or services at the open market value thereof: Provided further that the open market value of those goods or services shall not be deemed to be consideration for a financial service as contemplated in this paragraph"

[17] s 23(3) of the VAT Act.
[18] Williams (n 11) 41.

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This definition is subject to an important proviso to the effect that these activities[19] shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost. The importance of this proviso is that while the provision of the service itself is an exempt supply, any fee, commission, merchant's discount or similar charge in relation thereto is not exempt. Similarly a fee charged for the giving of advice on any of the financial services given will not be exempt, as are bank charges on an overdraft account, or any account. However, interest on an overdraft account would be exempt.[20]

Zero rating of supplies of financial services takes precedence over exemptions of such supplies. As such a financial service is exempt to the extent that it is not zero rated.[21] Thus, financial services supplied to a non-resident, even if physically rendered in South Africa, would be zero rated if the services are rendered directly to that non-resident and or any other person and both the non-resident and that other person are not in South Africa at the time the services are supplied. De Koker and Kruger emphasise an important point that[22]

> "[t]he VAT status of financial services can change from exempt to zero-rated when supplied to a recipient in an export country or when physically rendered outside the republic or under any circumstances envisaged by section 11…This status can have important and beneficial consequences for suppliers of financial services, whose percentage recovery of input tax could be significantly increased if certain of their transactions were identified as zero-rated, that is being taxable as opposed to non-taxable supplies, in appropriate circumstances."

Banks are the main suppliers of the above-listed activities. It is, however, cautioned that other businesses also do provide these services and would still be provided as financial services with the same treatment as they would be supplied by banks.[23] As stated above the extent to which the vendor would claim the deduction would depend on the values of the taxable versus exempt supplies.

[19] In particular activities contemplated in paragraphs (*a*), (*b*), (*c*), (*d*) and (*f*) of the definition of financial services.
[20] Stiglingh *Silke: South African Income Tax* (2015) 950.
[21] s 12(a) of the VAT Act.
[22] De Koker and Kruger (n 10) 6-3.
[23] See FSP Business "Revealed: Eight Vat-exempt financial services" accessible on http://fspbusiness.co.za/articles/vat/revealed-eight-vat-exempt-financial-services-2810.html (27 September 2016).

Banks are regulated by the Banks Act.[24] The Banks Act provides for activities that may be undertaken by the bank as the business of a bank. "The business of a bank" is defined as follows:[25]

> "**the business of a bank**" means -
>
> (a) the acceptance of deposits from the general public (including persons in the employ of the person so accepting deposits) as a regular feature of the business in question;
>
> (b) the soliciting or advertising of deposits;
>
> (c) the utilization of money, or of the interest or other income earned on money, accepted by way of deposit from the general public as a regular feature of the business for the following
>
> a. the granting by any person, acting as lender in such person's own name, or through the medium of a trust or a nominee, of loans to other persons;
>
> b. investment by any person, acting as investor in such person's name or through the medium of a trust or a nominee; or
>
> c. the financing by any person of any other business activity conducted by such person in his or her own name or through the medium of a trust or a nominee'
>
> (d) the obtaining, as a regular feature of the business in question, of money through the sale of an asset, to any person other than a bank, subject to an agreement in terms of which the seller undertakes to purchase from the buyer at a future date the asset so sold or any other asset; or
>
> (e) any other activity which the registrar of banks has after consultation with the Governor of the Reserve Bank declared by notice in the Gazette to be the business of a bank."

[24] Act 94 of 1990.

[25] The definition of the business of a bank excludes the following:

"(aa) the acceptance of a deposit by a person who does not purport to accept deposits on a regular basis and who has not advertised for or solicited such deposit : Provided that –

(bb) the borrowing of money from its members by a co-operative subject to such conditions as may be prescribed;

(cc) any activity of a public sector, governmental or other institution, or of any person or category of persons, designated by the Registrar, with the approval of the Minister, by notice in the *Gazette*, provided such activity is performed in accordance with such conditions as the Registrar may with the approval of the Minister determine in the relevant notice;

(dd) any activity that is the business of a bank if it is (i) performed by any institution registered or established in terms of, by or under any other Act of Parliament and designated by the Minister by notice in the *Gazette*; or (ii) performed in terms of any scheme authorized and controlled by, and conducted in accordance with the provisions of, any other Act of Parliament and so designated by the Minister,

(ff) the effecting, subject to the provision of any other Act of Parliament and to such conditions, if any, as the Registrar may from time to time determine by notice in the *Gazette*, of a money lending transaction directly between a lender and a bank as borrower through the intermediation of a third party who does not act as a principal to the transaction (hereinafter in this paragraph referred to as the agent),

(gg) the activities, set forth in subparagraphs (A) and (B) hereunder, of a person (hereinafter in this paragraph referred to as the mandatary) that –

(i) is a natural or juristic person registered in terms of, or a juristic person established by or under, any other Act of Parliament and the main business activities of whom or of which are regulated or controlled in terms, by or under such other Act of Parliament; and

(ii) has been designated by the Registrar by notice in the *Gazette*, which mandatary, for purposes of effecting a money lending transaction with a bank –

(A) accepts money from the mandator in terms of a prescribed contract of mandate; and

(B) in the execution of the mandate, and subject to such conditions as the Registrar may determine in the notice referred to in subparagraph (ii) above, deposits such money into an account maintained by the mandatary with a bank, irrespective as to whether or not such money is so deposited together with money so accepted by the mandatary from other mandators."

The definition of business of a bank in the Banks Act is broad and simplistic. It does not specifically cover most of activities that banks in this century undertake. However, the registrar of banks has, in terms of para (e) of the definition of "the business of the bank" issued regulations that expand on the business of the bank definition.[26] Those regulations sufficiently extend the business of a bank to cover those activities that are financial services for purposes of section 2 of the VAT Act.

The increased VAT cost on banks due to financial services exemption and imposition of VAT on fees, commissions and similar items is not experienced in countries where the financial services together with fees, commissions or similar charges attendant thereto are exempt. For example, in terms of the Ugandan Value Added Tax Act Cap 349 ("the Ugandan VAT Act") a supply of financial services is an exempt supply.[27] "Financial services" is defined in the second schedule to the Ugandan VAT Act. The main elements of the definition are similar to those of the definition in the VAT Act.[28] However, the definition of financial services does not exclude fees, commissions or similar charges. The effect, therefore, is that fees, commissions and similar charges attendant to financial services are equally exempt from VAT. In addition an import of a service is an exempt import if the service would be exempt if it had been supplied in Uganda.[29]

The Kenyan Value Added Tax Act lists a number of financial services that are exempt supplies.[30] No mention is made of fees, commissions or similar charges. However, in addition to these normal services, the provision of any of the listed financial services on behalf of another on a commission basis is an exempt supply which implies an exemption of such commission and similar charges.[31]

### 5 *Imported services*

Imported services are a supply of services by a supplier who is resident or carries on business outside the Republic to a recipient who is a resident of the Republic to the extent that such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies.

The VAT on the supply of imported services is calculated and paid by the recipient of the imported services primarily because of jurisdictional issues. The recipient is required to furnish the Commissioner of the SARS within 30 days of the date of supply with a return, calculate the tax payable on the value of the imported services and pay such tax to the Commissioner. If the recipient is a vendor, the vendor is in addition to the above required to furnish the Commissioner with a return

[26] See regulations on South African Reserve Bank, Regulation and Supervision accessible on https://www.resbank.co.za/RegulationAndSupervision/BankSupervision/BankingLegislation/Pages/default.aspx (04 October 2016).

[27] s 10(1) of the Ugandan VAT Act read with the Second Schedule to the same Act.

[28] Financial services is defined to mean the granting, negotiating and dealing with loans, credit, credit guarantees, and any security for money, including management of loans, credit, or credit guarantees by the grantor; (ii) transactions concerning deposit and current accounts, payments, transfers, debts, foreign currency sales and purchases, cheques and negotiable instruments, other than debt collection and factoring; (iii) transactions relating to shares, stocks, bonds and other securities, other than custody services; (iv) the management of investment funds; but does not include provision of credit facilities under a hire-purchase or finance lease agreement.

[29] s 20A of the Ugandan VAT Act.

[30] Part II(1) of the First Schedule to the Kenyan Act 2013.

[31] Part II(1)(m) of the First Schedule to the Kenyan Act 2013.

reflecting information required for purposes of the calculation of the VAT.[32] This is commonly referred to as reverse VAT.

A supply of imported services is deemed to take place at the time an invoice is issued by the supplier or recipient in respect of that supply or the time any payment is made by the recipient in respect of that supply, whichever time is the earlier.[33] The value of the supply of imported services is the greater of the value of the consideration for the supply or the open market value of the supply.[34] It was decided in the cases of *Metropolitan Life v Commissioner of the South African Revenue Service*[35] and *Commissioner of the South African Revenue Service v De Beers Consolidated Mines Ltd*[36] that the place of supply is the place where the services are applied and not where they are physically rendered.[37]

If a non-resident company renders services to its own South African branch it may not be clear as to which entity renders services to the other. Under normal rules, services provided to the South African enterprise in the course of the non-South African activities might not be considered taxable, since such services would not be furnished to a person with a legal identity different from that of the supplier.[38] Section 14(4) clarifies this position by deeming such services to be imported services if they would have been imported services had they been rendered by someone else. The South African branch would account for such services as imported services.[39]

It is not required that services, on the importation thereof be supplied by a vendor. It is also not required that the person providing the service "supplies" such services in accordance with the definition of "supply" in section 1 nor that the person supplies such services in the course or furtherance of any enterprise carried on by him.

Two important exemptions to imported services are provided in section 14(5). The first provides that the tax chargeable in terms of section 7 (1) (*c*) shall not be payable in respect of a supply which is chargeable with tax in terms of section 7 (1) (*a*) at the rate provided in section 7. This implies that where tax is chargeable under normal rules, that is, where the services are provided by a person that is registered as a VAT vendor in South Africa the recipient does not have to account for VAT. Considering that the definition of "vendor" in section 1 defines a vendor as *inter alia* a person that is required to register as a vendor, if a non-resident providing a service is required to register as a vendor, then the VAT is chargeable in terms of section 7(1)(a). This implies that the recipient is absolved from the liability to account for VAT in terms of section 7(1)(c).[40]

[32] s 14(1) of the VAT Act. See also Nieuwoudt *Income Tax and VAT Workbook* (2011) 79.
[33] s 14(2) of the VAT Act.
[34] s 14(3) of the VAT Act.
[35] (2008) 70 SATC 162 (C).
[36] 2012 (5) SA 344 (SCA).
[37] Van Zyl "Determining the place of supply or the place of use and consumption of imported services for value added tax purpose: some lessons for South Africa from the European Union" 2013 *SA Merc LJ* 542.
[38] See De Koker and Kruger (n 10) 8-12.
[39] S 14(4) provides as follows: "Where a person carries on activities outside the Republic which do not form part of the activities of any enterprise carried on by him and in the course of such first-mentioned activities services are rendered for the purposes of such enterprise which, if rendered by anybody other than the said person, would be imported services, such services shall for the purposes of section 7 (1) (*c*) be deemed to be imported services supplied and received by that person in respect of such enterprise."
[40] See De Koker and Kruger (n 10) 8-10.

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The question that arises in this regard is whether the recipient has facilities to determine whether the non-resident should register for VAT. If the service provider is registered for VAT, then the invoice would indicate that fact and the recipient would know not to account for VAT directly to the SARS. If the recipient receives services the consideration for which exceeds R1 million, that is a clear determination that the service provider should register for VAT (subject to all other requirements being met). If, on the other hand the recipient only pays less than R1million, the recipient could not make such determination without confirmation from the service provider.

The second provides that the tax chargeable in terms of section 7 (1) (*c*) shall not be payable in respect of— (*b*) a supply which, if made in the Republic, would be charged with tax at the rate of zero per cent applicable in terms of section 11 or would be exempt from tax in terms of section 12. If financial services are rendered to a resident by a resident entity, such supply would be exempt from VAT. Therefore, financial services provided by a non-resident, where the non-resident is not registered and is not required to be registered for VAT would be exempt from imported tax imposition. It therefore follows that if imported financial services are supplied to a resident and a fee or commission is charged to the resident, the financial service itself would be exempt from tax, while the fee or commission attendant thereto would be subject to the reverse VAT provision.

If the supply is for purposes of making taxable supplies the recipient does not account for VAT on the receipt of the services but charges VAT on the supply of the services.

While it appears clear that in the case where the non-resident is a vendor because the non-resident is required to register for VAT, the resident recipient is absolved from the obligation to reverse VAT, this absolution depends on whether the supplier is required to register, something that might not be in the custody of the service recipient to know. There is no automatic absolution from the VAT registration for the service provider where the recipient accounts for reverse VAT (assuming that the provider only renders services to the service recipient).

The Zambian law provides for a situation in which a resident taxable person may act as an agent for a non-resident. If a tax agent is appointed, the agent invoices the recipient of the services for the VAT payable, collects the tax and accounts for it to the Zambian Revenue Authority. The recipient of the services may claim input tax relief on the basis of the invoice issued by the tax agent.[41] In some jurisdictions, the reverse VAT is linked to a percentage of the use of the service in providing taxable supplies. In Canada, for example, a self-assessment in the form of a reverse charge of the GST is required on importations of intangible personal property and services that are acquired from unregistered, non-resident persons outside Canada and not used at least 90% in commercial activities (100% in the case of financial institutions).[42] In the United Kingdom the reverse charge is mandatory and applies where services are bought in from anywhere outside the United Kingdom, even when the supplier is part of the same corporate group.[43] Under the procedure, whereby a UK business receives services from a foreign parent, the UK business is required to account for output VAT based on the value of the supply received.

[41] See Ernst & Young Worldwide VAT, GST and Sales Tax Guide (2016) 1077.
[42] See Ernst & Young (n 41) 145.
[43] Black *Explaining Tax Principles: Elementary* (2011) 14.

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Expressing the high cost faced by banks with regards to imported services, the Davis Tax Committee (DTC) notes that the non-deductible VAT cost to the banks is significantly increased where any function in supplying the financial services is outsourced because these services, which were previously exempt from VAT, are now taxable, and the banks are only entitled to claim a portion thereof as input tax.[44] The increase in the VAT cost is mainly due to the VAT exempt personnel cost which is included in the fee that is charged for the outsourced service on which VAT is levied, for which there is no corresponding input tax deduction. Examples listed by the DTC of the outsourced transactions which result in a non-recoverable VAT cost to banks include the following:

- The supply of support services such as human resources, information technology, treasury, finance and legal services;
- The employment of staff by one company in a group and the deployment of such staff in other companies and branches within the group;
- Loan origination and valuation services;
- Centralised customer call and service centres;
- Management and administration services; and
- Provision of infrastructure such as buildings and equipment.

The functions and transactions outlined in the DTC report are clearly and expressly those that are rendered by banks, and to a limited extent by other finance houses. It is also argued that this vertical integration disadvantages small financial institutions as well as frustrates the natural development of the financial sector.[45]

## 6 *VAT apportionment*

As stated, VAT directly related to making taxable supplies is recoverable, while VAT directly related to making exempt supplies is not recoverable. The main category of persons with problems in identifying the amounts of input tax available for credit is businesses that make some taxable supplies and some exempt supplies, often so-called mixed supplies or partial exemption. Most countries exempt financial services; consequently, banks and other suppliers of financial services routinely confront the problems of partial exemption.[46] Williams provides the following example:[47]

> "a finance house makes supplies of financial services, which are exempt, and also supplies business advice that is subject to VAT at the main rate. The finance house is a heavy user of telephones and incurs a substantial amount of VAT on its telephone bills. If the finance house were allowed to claim all the input tax on its telephone bills, it would be receiving excessive input tax. The law therefore allows the finance house to claim the VAT on the telephone bills that relate to its business advice services but not to its financial services."

[44] Davis Tax Committee *Value-Added Tax – First Interim Report on VAT to the Minister of Finance* (2014) 46.

[45] Schenk and Oldman *Value Added Tax: A Comparative Approach* (2007) 317; Schenk "Financial Services" in Krever (ed) *VAT in Africa* (2008) 31 – 46; *Report of the VAT Sub-Committee into the Taxation of Financial Services* (Government Printer Pretoria 1995) par 4.2.3.

[46] Williams (n 11) 218.

[47] Williams (n 11) 218.

The construct of the South African VAT Act is such that the fees and commission charged on financial services are not exempt, and thus embedding this problem (partial exemption) as a permanent feature for banks. There are significant practical problems in attempting to divide each item of input and as a result a variety of solutions have been adopted in practice, such as averaging or estimating or generalizing from a partial audit of input tax.[48] To resolve this problem, the VAT Act provides for an apportionment of the input tax. Section 17(1) provides as follows:

> "where goods or services are acquired or imported by a vendor partly for consumption, use or supply (hereinafter referred to as the intended use) in the course of making taxable supplies and partly for another intended use, the extent to which any tax which has become payable in respect of the supply to the vendor or the importation by the vendor, as the case may be, of such goods or services or in respect of such goods under section 7 (3) or any amount determined in accordance with paragraph (*b*) or (*c*) of the definition of "input tax" in section 1, is input tax, shall be an amount which bears to the full amount of such tax or amount, as the case may be, the same ratio (as determined by the Commissioner in accordance with a ruling as contemplated in Chapter 7 of the Tax Administration Act or section 41B) as the intended use of such goods or services in the course of making taxable supplies bears to the total intended use of such goods or services"

This provision is subject to a proviso that the vendor may make the following input tax deductions:[49]

- The full tax deduction if the taxable use is not less than 95% of the total intended use. This is referred to as the *de minimis* rule); or
- The portion that relates to the taxable supplies if the taxable use is not less than 95%. In this regard the vendor apportions the input tax. Apportionment of input tax is compulsory where the services are acquired partially for taxable and partially exempt supplies. The vendor does not apportion output tax, and therefore no output tax is charged by the vendor on making supplies.

The Commissioner for the SARS has issued a binding general ruling contemplated in Chapter 7 of the Tax Administration Act,[50]Binding General Ruling on Standard Apportionment Ratio,[51] (BGR 16). The BGR expresses total taxable supplies as a percentage of taxable supplies. It provides for the following formula:

[48] Williams (n 11) 219. According to Williams the rules may be applied strictly for a trial period. During this period, the taxable person is required to identify any input tax paid on supplies acquired solely for the purpose of making taxable supplies, any input tax paid in connection with making supplies that are exempt, and the input tax to be apportioned. The input tax is apportioned in proportion to the total of taxable supplies and the total of exempt supplies (and, depending on how the law is structured, supplies outside the scope of the tax). This produces an overall ratio of taxable supplies to total supplies that might be, say, 40 percent. In the following year, unless either the tax administration or the taxpayer dissents, the same ratio of 40 percent can be used for allowing input tax without asking the taxable person to keep the same detailed records.

[49] proviso to s 17(1) of the VAT Act.

[50] Act 28 of 2011.

[51] Binding General Ruling (VAT) NO.16 Issue 2, dated 30 March 2015. First issued on 25 March 2013. Accessible on http://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BGR-2013-05%20-%20BGR16%20Standard%20Apportionment%20Method.pdf (04 October 2016).

$$y = \frac{a}{a + b + c} \times \frac{100}{1}$$

Where:

"y" = the apportionment ratio/percentage;

"a" = the value of all taxable supplies (including deemed taxable supplies) made during the period;

"b" = the value of all exempt supplies made during the period; and

"c" = the sum of any other amounts not included in "a" or "b" in the formula, which were received or which accrued during the period (whether in respect of a supply or not). The terms "received and accrued" are not defined in the VAT Act or in the BGR but case law on income tax ruled in *Geldenhuys v CIR*[52] and in *CIR v People's Stores (Walvis Bay) (Pty) Ltd*[53] that received means "beneficially received" and "accrued" means "unconditionally entitled to".

The term "value" excludes any VAT component. Furthermore, "c" in the formula will include items such as dividends and statutory fines (if any). The vendor must exclude from the calculation the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease or instalment credit agreement).[54] The vendor must also exclude value of any goods or services supplied where input tax on those goods or services was specifically denied. The percentage of taxable usage (as represented by c and d in the formula) is calculated only once a year and the same percentage is used for all inputs of that specific year if the supply is not wholly supplied for taxable or non-taxable purposes.[55] Vendors using their previous year's turnover to determine the current year's apportionment ratio are required to make an adjustment (that is, the difference in the ratio when applying the current and previous years' turnover) within six months after the end of the financial year.

According to the SARS the vendor may only use this method if it is fair and reasonable. Where the method is not fair and reasonable or inappropriate, the vendor must apply to SARS to use an alternative method. The effect of the apportionment ratio is that a bank is only allowed to recover part of the VAT relating to the taxable supplies made by the bank. In relation to the non-taxable supplies, the bank is deemed to be a consumer of the supplies and bears the full burden of the VAT.

The problem with this standard apportionment ratio is that it requires vendors to include as non-supplies in the formula any other amounts which are not classified as taxable or exempt supplies and which were received or accrued during the period, irrespective of whether these amounts were received in respect of a supply or not. However, an immediate solution to this is that the vendor may apply to the SARS for an alternative method on the basis that the standard method is

[52] 14 SATC 149.

[53] 52 SATC 9.

[54] This exclusion only applies to a vendor that does not usually supply capital items on a regular basis as a normal part of the business, unless such items are supplied under an instalment credit agreement.

[55] Stiglingh (n 20) 974.

not fair, reasonable or appropriate. According to Ernst & Young, SARS clearly views apportionment of input tax as a primary generator of revenue and vendors across all sectors can expect a knock on the door and to be challenged on input tax claimed in full.[56]

VAT apportionment is quite popular in developed tax regimes. For example New Zealand has a detailed and comprehensive apportionment methodology including an option for the taxpayer to choose to use a fair and reasonable method of apportionment, as agreed with the Commissioner, in relation to the supply for an apportionment on acquisition.[57] Developing VAT regimes are also following suit. For example, the Ghana Revenue Authority (GRA) started the enforcement of the VAT on some financial services in January 2015 in terms of the Value-added Tax Act 870. Act 870 only allows a deduction for input tax that is directly attributable to the provision of fee-based financial services and are not permitted under Act 870 to apportion total input tax incurred on all operations between taxable and exempt supplies. Only VAT incurred exclusively for the provision of taxable services will be allowed.[58] With the responsibility to charge VAT banks are entitled to deduct input tax incurred in providing the taxable services and other VAT registered persons are entitled to deduct the VAT charged by the banks on financial services, subject to the general VAT deductibility rules.

## 7 *Conclusion*

The South African tax system is developing along with business practices, and with these developments comes complexities in the system as well as strengthened enforcement of the laws. As has been illustrated, the complications brought about by the exemption of financial services from VAT but the inclusion of fees, commissions and similar charges have various implications for banks. Undoubtedly it increases the VAT compliance burden for banks. In order for a bank to comply with the apportionment, it needs to determine its total supplies as well as taxable supplies accurately. In some instances the bank would also have to determine other amounts such as dividends and statutory fines. The VAT apportionment ratio then has to be applied to all inputs by the bank, including on imported services. The imported services in this regard could be services of the employees of a head office to its local branch. This brings with it the already complex provisions relating to a reverse charge on imported services.

As indicated by various writers, the apportionment (ie the inability of the banks to claim a refund of the full input tax) increases the business costs to the banks. It needs to be noted, however, that a charge of VAT is on the consumer of the goods and services involved. An apportionment relieves the bank of a fraction of the VAT. The percentage of the input tax claimable by a bank often justifies the resources placed towards the claim thereon.

[56] See Ernst & Young "VAT apportionment" https://www.saica.co.za/integritax/2011/1912.%C2%A0VAT_apportionment.htm (04 October 2016).

[57] s 12(3E) of the New Zealand Goods and Services Tax 1985.

[58] See PWC "VAT on Financial services" accessible on http://www.pwc.co.za/en/assets/pdf/on-point-vat-on-financial-services-3rd-edition.pdf (28 September 2016).

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# How to rob a bank: land tenure information systems*

LESLIE DOWNIE**

**ABSTRACT / SUMMARY**

An accurate national land information system is necessary for land to be used as security in a sustainable manner. In the past the South African deeds registry has been regarded as the main custodian of verifiable land information. Banks build up various records of land rights as part of their lending function. These mechanisms are used to create private internal records, not to collate information that can contribute to stabilizing the broader land information system. Bank records are not generally seen as a means to cross check information in the deeds registry. Nevertheless, the banking sector needs to keep abreast of current public land information system challenges. They pose a very serious new category of risk, both for private holders of rights and for government. A number of new land bills are currently on the table, many of which include processes for determining legitimate claimants. The Regulation of Agricultural Landholding Bill, the Expropriation Bill, the Extension of Security of Tenure Bill and the Communal Land Tenure Bill are cases in point. These bills will trigger new land information system requirements that will have to function alongside the deeds registry system, a system which is already under strain. The nature of unregistered rights will need to be determined and categorised before compensation can be determined. The information relevant to unregistered rights raises the same complications seen in the South African subsidised housing arena. One in three residential properties registered in the Deeds Office is a previously state subsidised house. There are numerous problems with the currency and accuracy of information relating to these registrations. For vast numbers of South Africans the current Deeds Office processes appear not to be in the public interest. These problems must not be repeated with the land information that needs to be collected before effect can be given to the new legislation. Accurate and reliable records relating to land tenure are central to the core functions of banking. Banks could play an important role in facilitating good governance benchmarks for future land record keeping in South Africa.

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** BAHons (English) LLB MPhil (Geomatics). Attorney, notary, conveyancer and mediator with Michalsons Attorneys Cape Town. https://www.michalsons.com/about-michalsons/our-people/leslie-downie. Affiliate member of South African Geomatics Institute (SAGI). https://www.michalsons.com/?s=Land+Information+Systems&lang=en.



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An accurate national land information system is necessary for land to be used as security in a sustainable manner. The South African banking sector needs to keep abreast of current land tenure information challenges. These challenges will either create serious new categories of risk, or alternately offer important opportunities to entrench rights. The most effective way to rob a bank is to rob it in a way that no formal record can trip any internal alarms. A title deed with an inaccuracy in the favour of an unscrupulous person is the golden key to a very effective getaway car. It enables the title-holder to drive off undetected with the rights of others. Then the land is not stolen *in spite of* our stringent deeds registry system. The heist is accomplished by what is put into the deeds registry in the first place.

There are a number of new land bills on the table in South Africa. Once they come to fruition it will be necessary to collect data for a variety of unregistered occupation rights that function alongside private ownership rights. Some of these rights and interests are not yet clearly defined by law. Examples of these new bills are the Expropriation Bill,[1] the draft Land Management Commission Bill,[2] Extension of Security of Tenure Bill,[3] Communal Land Tenure Bill and Regulation of Agricultural Landholding Bill.[4] Section 1 of the Expropriation Bill defines an "unregistered right" as meaning "a right in property, including a right to occupy or use land, which is recognised and protected by law, but is neither registered nor required to be registered".[5] The phrase "neither registered nor required to be registered" could be interpreted in a number of different ways, including the rights of tenants, farm workers and residents and customary use rights.[6] When there is little documentation supporting such rights, formal examples giving guidance on how to prove such rights become limited. Attention should therefore be paid to the spread of occupation rights to government-subsidised housing that are not registered in the deeds registry. These unregistered rights are much more closely aligned to the formal records of registered right-holders. A functional land tenure information system is central to the safe passage of the land reform endeavour, both for the government and for the private sector. Understanding the successes and shortcomings of the recording of land information for government-subsidised housing can offer rewarding insights.

Banks will need to develop mechanisms to cope with the land bills if they are to determine the value of land held as security for loans. When land is expropriated the value of unregistered rights will be taken into account when deciding how much of the compensation will go to the owners of land, unregistered right-holders and the bank. The Banking Association of South Africa's presentation to Parliament on the Expropriation Bill recommended that data regarding the notice of expropriation be captured and maintained in a publically accessible

[1] GG 38418 (26-01-2015).
[2] GG 36880 (27-09-2013).
[3] GG 36942 (17-10-2013). See explanatory summary GG 39232 (25-09-2015).
[4] For a simple discussion of these bills see http://www.sanews.gov.za/south-africa/land-holdings-bill-be-presented-cabinet (26-09-2015) and http://agbiz.co.za/uploads/AgbizNews16/Presentations/Land%20Reform%20Status.pdf (26-09-2015).
[5] A "holder of a right" is defined as the holder of an unregistered right in property.
[6] In the s 1 definitions of the Restitution of Land Rights Act 22 of 1994 an unregistered right in land includes the interest of a labour tenant and sharecropper, a customary law interest, the interest of a beneficiary under a trust arrangement and beneficial occupation for a continuous period of not less than 10 years prior to the dispossession in question.

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register, to avoid credit providers being adversely affected.[7] Credit providers also need to consider the adverse consequences if these notices include inadequate land tenure information regarding either registered or unregistered right-holders. The microcosm of household information relevant to government-subsidised housing illustrates these consequences very well.

Subsidised private properties are registered at the Deeds Office, but banks also hold internal records for those that are linked to bank financing. The National Treasury's draft market conduct policy framework under discussion is clear on the need for fair treatment of customers, particularly customers with low financial literacy.[8] The focus must be on fairness and integrity. Many bank customers with low financial literacy will be recipients of government subsidies. New benchmarks will adjust the way banks interact with such customers when they collect information to assess their creditworthiness. Banks could potentially use these processes to archive critical land tenure information that is currently at risk of being overlooked. Some of this information is likely to be relevant to the unregistered rights referred to in the land bills, particularly when residential right-holders are relocated to subsidised housing. As will be discussed below, there are already certain shortages of current information on state-subsidised housing in the deeds registry. In addition to this, it will be difficult for the state to meet the increased demand for land records that will be generated by the new bills. This raises the need to urgently consider private initiatives that could assist the state. This paper will illustrate this from the perspective of banks and current subsidised housing land tenure information.

The scale of information required for subsidised housing records is immense, and collation is undertaken under considerable pressure. Government subsidies have provided 3.7 million houses from inception of the democratic government in 1994 until 2014. These properties house 12.5 million people, being 25% of South Africa's population.[9] In 2011 25% to 30% of all residential properties registered in the South African deeds registry were products of government subsidies.[10] Housing records must however go far beyond those who have already received housing, now already more than a quarter of the South African population. The records must also include all those on the housing waiting list, as well as various interim categories. Many of the people from whom this information must be sourced are not in possession of all their own formal documentation and have difficulty in obtaining it. It is estimated that by 2050 70% of the world population will live in cities, with the housing challenges immense.[11] Many more subsidised properties

[7] Regarding s 26 (1) and s 9. See http://www.banking.org.za/news-media/publications/presentation-submissions/expropriation-bill-parliamentary-presentation (26-09-2015).

[8] National Treasury *Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy for South Africa* Discussion document December 2014.

[9] Department of Human Settlements *Celebrating 20 years of Human Settlements: Bringing the Freedom Charter to Life* (2014) 4 4,12 and17. Added to this figure are further state-funded properties from the previous dispensation.

[10] Gordon, Nell and di Lollo *Investigation Into the Delays in Issuing Title Deeds to Beneficiaries of Housing Projects Funded by the Capital Subsidy* (2011) 24 <http://www.urbanlandmark.org.za/downloads/title_deed_delays_report_2011.pdf> (21-02-2015).

[11] Augustinus "Social Tenure Domain Model: What It Can Mean for the Land Industry and for the Poor" *Proceedings of the XX1V FIG International Congress, 11-16 April 2010, Sydney, Australia* (2010) 4.

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will need to be registered in the future in South Africa.[12] While there may be shortcomings with the housing land information system, the successes achieved should not be underestimated in the light of the magnitude of the task.

The nature and archiving of subsidised housing information is different according to the needs of the stakeholders holding it. The Department of Human Settlements drives the initial information gathering process, assisted by municipal housing officials, developers and other contractors. The Deeds Office then records that stream of this information that feeds into the formal land deeds registry, via the professional services of conveyancers. The Deeds Office record is open to the public, but access is difficult if you are indigent or low-literate. The accuracy of land information data of people in subsidised housing is a critical national issue. It might, however, shortly be overtaken by the record-keeping needs generated by the new land bills. It is therefore a good time to take stock of lessons learned in the microcosm of small, subsidised houses. Many of the challenges are similar to those that will be encountered for rural, and larger land holdings.

South African subsidised housing has (for many years) been awarded on a sole or co-ownership basis, through a variety of subsidies aimed at assisting the poor. Private ownership is not necessarily the subsidised housing tenure mechanism used in all rural areas in South Africa, due to customary and farm subdivision considerations. Statutory changes to ownership registration may be considered in the long term for urban subsidised housing. However, existing sole title rights within a paradigm of group household rights are inevitable in urban areas for the foreseeable future. Dependents are not reflected in any way in the title deeds, as is the case with most other private residential land ownership. More particularly, a dependent's right to housing (or other support from their caretakers) is not registered against the title deed. It is therefore extremely difficult for vulnerable dependents to assert their rights in times of household conflict.

Conceptually (in some respects) this mirrors the difficulties faced by unregistered right-holders *vis a vis* owners that are covered by land reform statutes and bills. It is therefore helpful to consider aspects from the subsidised housing arena relevant to the recording of unregistered rights. Subsidised housing data gaps in the deeds registry occur for a variety of reasons. One example is when current title deed information no longer reflects the persons entitled to ownership. Another is when the title deed inaccurately reflects marital status. A further gap arises due to dependents (that are entitled to housing benefits) not being reflected in the records. Lastly, "norm shopping" and hybrid approaches to culture and the law (seen in the manner people access housing) are relevant. These themes are wide ranging. No attempt will be made in this paper to cover the finer points, only broad outcomes relevant to unregistered rights. The term "unregistered rights" is used loosely to refer to concepts that are similar, not according to the specific definitions of unregistered rights under various laws.

The problems for maintaining records reflecting current ownership rights will be discussed first. The use of informal tenure practices varies with South African

[12] The means test threshold for the individual housing subsidy is a combined gross household income of less than R3 500 per month. The finance linked individual subsidy threshold is a household income of between R3 500 and R15 000. Western Cape Department of Human Settlements *Individual Housing Subsidy Programme* and *Finance Linked Individual Housing Subsidy Programme* unpublished information pages available at the Western Cape Department of Human Settlements help desk on 21 May 2015.

state-subsidised houses, but was noted by Barry and Roux in a 2015 study as pervasive in some areas.[13] Informal practices manifest in different ways.[14] The disjunction in official records of formally identified housing beneficiaries (entitled to ownership) and the actual occupiers is broadly recognized, although the extent and the reasons for it are contested.[15] Nevertheless, it is clear that many subsidised housing occupiers are no longer the official beneficiaries. Research in areas like De Noon in the Western Cape show a divergence of 39% between the occupiers and the original beneficiaries.[16] In many of the areas showing a divergence (between occupants and state beneficiaries) registration of the original beneficiary's ownership has been delayed due to government processes.[17] Great uncertainty can be caused arising from changes in household structures (and personal conflicts) in the intervening years. In tandem with these delays, policy and constitutional changes surrounding gender (and in whose name title should be reflected) have undergone change. Urban migration and dual household membership further problematises identification of household structures over time.[18] All of these issues trigger substantial land information system challenges, as a secondary outcome of land administration systems for housing poverty relief.

One of the more obvious causes of the lack of currency of ownership data in the deeds registry is poverty. The poor's lack of access to legal education, advice and remedies is a widely recognised problem. The 2015 cost of registering transfer of ownership of a house valued below R100 000 (according to the Law Society guidelines) was R3 950 before the additional costs for rates certificates, deeds office fees and the like, with the disbursements taking it up to approximately R5 320.[19] Housing beneficiary couples are often not able to register transfer of a half or whole share of their subsidized property if their relationship breaks down. Transfers of ownership due to deceased succession are often not registered

[13] Barry and Roux "Land Narratives and Land Registration in State-Subsidised Housing in South Africa" *Proceedings of the FIG Working Week, 17-21 May 2015, Sofia, Bulgaria* Paper 7852 (2015) passim <http://www.fig.net/resources/proceedings/fig_proceedings/fig2015/papers/ts06b/TS06B_barry_et_al_7852.pdf > (10-07-2015) and Roux *Land Registration Use: Sales in a State-Subsidised Housing Estate in South Africa* (2013) Phd thesis Calgary Alberta (2013) 220-230.

[14] Current land tenure thinking takes as much cognizance is taken of informal practices amongst the poor as of the formal law. For the purposes of this article "formal" means any practice or interest that is, or can be, recognized and entrenched by recourse to existing legal processes and rules. "Informal" means any practice or interest that either *is not*, *or cannot be*, recognized and entrenched by recourse to existing legal processes and rules.

[15] Barry and Roux (n 13).

[16] Gordon et al (n 10) 21.

[17] Gordon et al (n 10) 21. The number of outstanding title deed registrations has been significantly reduced due to concerted efforts in recent years. Western Cape Government website *2013 State of the Province Address by Premier Helen Zille* http://www.westerncape.gov.za/speech/2013-state-province-address-premier-helen-zille (24-02-2015).

[18] See Posil and Marx *The Interaction between Informal Land Markets and Urban-Rural Migration – Final Research Report* (2011) <http://www.urbanlandmark.org.za/downloads/land_markets_migration_2011.pdf> (21-02-2015).

[19] GhostDigest "Conveyancing Tables" *GhostDigest Conveyancing News and Views* 29-05-2015 <http://www.ghostdigest.co.za/articles/conveyancing-tables-may-2015/54786>(29-05-2015) and Fairbridges Attorneys *Conveyancing Cost Calculator* 2015 <http://www.fairbridges.co.za> (29-05-2015).

due to the high cost of registration and other social factors.[20] Informal practices and norms are therefore deeply entrenched in the approach to succession and the secondary market of subsidised housing.[21] This is not surprising, since the conveyancing cost for subsequent transfers of previously subsidised houses is beyond the reach of most poor titleholders. As Holness notes, it is apparent that "access to a lawyer in civil matters is for well-off South Africans only".[22] Informal sales of state-subsidised housing could therefore be defined as falling within the category of "unregistered rights," as could rights to succession where an estate has not been reported, which is common. This lack of registration makes it easy to sell and transfer such land without the knowledge of a buyer or heir. This mirrors the manner in which advantaged owners might now be able to alienate land free of the unregistered rights the land reform measures seek to protect.

A second major cause of data gaps in the deeds registry is gender related. High volumes of men had the ownership of state-funded houses registered in their name alone in the past.[23] In recent years land has been registered as co-ownership for both cohabiting and married partners. Historically, however, it was common for only the mens' right of possession and ownership to be recorded at the Deeds Office. This enabled (and might be continuing to enable) unobstructed disposal of the land. The rights of these wives and partners could therefore be defined as "unregistered rights."[24] This lack of registration makes it easy to sell and transfer such land without the knowledge of a wife or partner. Banks (in their capacity as mortgagees) hold original title deeds confirming ownership rights. They should not assume that the ownership details are accurate in all instances, particularly for subsidised housing and marital status. Inaccurate information in the title deed can be made to align with an inappropriate land transaction excluding the rights of a spouse. The disposal can then move through the conveyancing and banking system quite smoothly. The marital status affidavit that is signed as part of the conveyancing process is slender protection if faced with an alienated romantic partner. The way an owner could alienate subsidised property without the knowledge of their partner highlights the types of issues faced by the unregistered right holders the new land bills seek to protect.

Apart from conveyancing conventions that did not include civil wives in title deeds in the past, a further factor is that many customary marriages are not registered. This means it is difficult for a conveyancer to pick up the existence of either a civil or a customary wife if the title-holder does not disclose this in their status affidavit. South Africa's formal marriage statistics are based on the

[20] Where there is no will, the Intestate Succession Act 81 of 1987 and the Reform of Customary Law of Succession and Regulation of Related Matters Act 11 of 2009 provide for succession. Capacity to inherit is according to blood relationship or as a spouse. Spouses include certain unregistered customary, Muslim and Hindu marriages, as well as same-sex life partnerships that have agreed reciprocal duties of support.

[21] McGaffin and Wanjiko Kihato "Defining Markets: A Set of Transactions between Actors" in Napier, Berrisford, Kihato, McGaffin and Royston *Trading Places: Accessing Land in African Cities* (2013) 21 34-37.

[22] Holness "Recent Developments in the Provision of Pro Bono Legal Services by Attorneys in South Africa" 2013 16 *PER* 129 129-130.

[23] De Vos *The Law of Marriage* (197?) 46 notes the registration practices in the past generally made it "impossible to see from the title deed of the property whether the property is owned by one person or jointly by spouses joined in community of property".

[24] For a more detailed discussion on unregistered domestic partner's proprietary rights see Coetzee Bester and Louw "Domestic partners and 'The choice argument': Quo vadis?" 2015 18 *PER* 2951-2981.

Department of Home Affairs records, in which unregistered customary and religious marriages are not noted.[25] The statistics do however indicate that the majority of customary marriages are not registered in the year they occurred.[26] The statistics for "unmarried" cohabiting couples overall is high, with no easy way to determine whether cohabitation is based on an unregistered marriage. With respect to couples cohabiting outside of marriage, domestic partners are free to enter into a comprehensive contract agreeing their property arrangements. They can also use individual contracts for joint ownership or leases and draw a will appointing each other as heir. Failing this they can alienate their property without the consent of their partner. In practice domestic partnership agreements in the context of subsidised housing are extremely rare. The housing rights of *de facto* domestic partners in relationships initiated after the original registration of ownership will not be reflected in the title deed. Their housing rights could, therefore, also be interpreted as "unregistered rights."

A third major cause of "unregistered rights" relates to the rights of dependents of individuals or couples that acquire state-subsidized housing. A means test is undertaken for the household as a whole, as part of the process of applying for a subsidy. The subsidy awarded is intended to facilitate housing for everyone in the needy household. Ownership title is registered either in the name of an individual adult, or a couple as co-owners. The owners' dependents are, however, owed a legal duty of support that includes housing. These duties and the associated rights are not registered against the title deed. So, for example, if a sole titleholder marries a new partner in community of property, prior dependents' housing rights are hugely at risk. The property can be sold without the interests of aged or young dependents being protected.[27] The death of the dependents' biological relative (who was the original title-holder) can also result in the subsequent spouse taking over the property.[28] A surviving spouse is likely to inherit the whole of the immovable property, as the minimum spouse's share is currently R250 000 (an amount usually in excess of the value of a subsidised house).[29]

Many conflicts in poor households begin when household relationships break down. Informal remedies to cure land conflicts can then be triggered by inaccessible records and a vacuum of legal solutions. Neither the state nor the current available legal aid outlets have the capacity to correct the following causes of household conflict that impact the land information system:

1. lack of security of housing tenure for cohabiting spouses without a marriage certificate or cohabitation contract
2. urban subsidised housing registration beneficiary policies that prioritized men
3. deficiencies in state databases of details of cohabiting partners from the past
4. effecting transfers if there are multiple intervening formal and informal sales
5. curing the effect of unreported estates on the transfer of ownership, or
6. offering access to courts for dependents to obtain the necessary redress and restitution for their right to housing security.

[25] Various marriages under Hindu, Islamic and other religious rites are not registered.
[26] Statistics South Africa *Marriages and Divorces 2013* 4.
[27] All sales are subject to state consent for a period of five to eight years from acquisition, in terms of ss 10A and 10B of the Housing Act 107 of 1997. This condition is however often not enforced.
[28] This also applies to the adult child of an elderly dependent who was given title.
[29] See Burman Carmody and Hoffman-Wanderer "Protecting the Vulnerable from 'Property Grabbing': The Reality of Administering Small Estates" 2008 125 *SALJ* 134 146. The danger of this is discussed in the article with reference to the previous threshold of R125 000.

All of these factors can result in exponential growth of inaccurate data in the deeds registry. Many of these situations result in what could be defined as "unregistered rights" in land. Land tenure that cannot be secured against those with whom someone is in a relationship is unlikely to be secure against the world at large.

There is a further aspect of subsidised housing that is highly relevant to the challenges of recording data for unregistered land tenure rights. UN-Habitat defines tenure as being based on "relationships between people and land directly, and between individuals and groups of people in their dealings with land".[30] Household conflicts over state-subsidised housing often reflect two competing views of land tenure, particularly when it comes to succession. One sees land tenure as best secured by means of private individual (or co-) ownership. The other does not see land tenure as best secured by private ownership, but rather as a group's customary right to the use of the land, buttressed by the right to limit the disposal of land in a manner that threatens such rights.[31] At root, most systems of belonging can be traced back to the personal intentions that manifest themselves in intimate relationships. How to accurately record interests based on cohabitation and household dependency is therefore central to tenure security under both worldviews. The difficulty of reconciling these views within the household (in a manner that protects unregistered rights of household members) poses similar challenges to those that will need to be faced when implementing the new land bills.

Marriage and succession norms are often forged in the context of legal pluralism. Legal pluralism arises when multiple systems of law exist alongside each other, as is the case with South Africa's civil law and the many traditional customary systems. Land ownership norms and the strength of unregistered rights are influenced by this legal pluralism. As Claassens and Smythe point out, in the broader customary context people "mix and match", as "claims are forged at the interface between overlapping systems of law and custom which combine the 'imported' and the local, the formal and the informal".[32] This is referred to as "norm shopping" with people cherry picking aspects from multiple legal systems to suit their interests. Hybridisation seems to have become an inevitable part of South African society,

[30] UN-Habitat *Monitoring Security of Tenure in Cities: People, Land and Policies* (2011) 5. "Tenure" simply defined is "a right, term or mode of holding or occupying something of value for a period of time" *Legal Dictionary: The Free Dictionary* <http://legal-dictionary.thefreedictionary.com/tenure> (20-06-2015).

[31] It is regularly stated in current land tenure debates that in Africa it is traditional to see people as belonging to land rather than the Western norm of land belonging to people. In the African conceptualisation, as extensively explored in Claassens and Smythe (eds) *Marriage Land and Custom: Essays on Law and Social Change in South Africa* (2013), land is seen as being managed by a person in a custodian manner. This guardianship on behalf of the family group is not readily reconcilable with the (Western) individual private ownership paradigm. Access to land is dependent on belonging, active participation and need, not due to rights that are claimed as a result of legal rules. In this frame extended family, particularly the elderly and siblings, have far greater prominence than in Western models, with the elected custodian expected to take up the broader duty of support according to family. Succession is seen as something to be determined by the surviving family, according to family need and norms of inclusion, not by individual testation. This worldview is discussed by the Constitutional Court in *Bhe v Magistrate, Khayelitsha* 2005 1 BCLR 1 (CC) with constitutional principles identified. Nevertheless, it must be remembered that informal practices often occur precisely when local norms differ from the formal legal norms.

[32] Claassens and Mnisi "Rural Women Redefining Land Rights in the Context of Living Customary Law" (2011) in Goldblatt and McLean (eds) *Women's Social and Economic Rights: Developments in South Africa* 80 86 and 103.

manifested not only in social practice but also in statutes.[33] Many couples live in communities where multiple worldviews are in the melting pot of change.[34] The formal law's ability to protect rights arising in this context is highly dependent on whether data regarding currently unregistered rights can be properly reflected in the land information system.[35] The definition chosen to record the nature of such rights is a key challenge. Norm shopping can be used to favour the powerful and disadvantage the weak. Today there is a forest of legislation empowering women. However, it is still possible for the land rights of certain categories of women to be totally invisible in the deeds registry. Female powers of decision-making, autonomy and control must be capable of protection if constitutional principles of equality are to be maintained. The same must apply to vulnerable men to avoid discrimination due to gender. Any process that leaves such rights unregistered enables inappropriate disposals of land tenure rights.

The deeds registry data is foundational to South Africa's land ownership system. State records usually serve as the basis of formal rights enforcement. On the private side, any disjunction between these records (and the reality of their context) can be what formalises miscarriages of justice against dependents by their own relatives or household. On the public side, a lack of records to track people who are capable of housing their dependents (but not willing to do so) can be the driver of perpetual dependence of poor citizens on the state. Banks build up various records of land rights as part of their lending function. These private internal records do not aim to collate information that can contribute to stabilising the broader land information system. However, new market conduct benchmarks will expect fair treatment of customers that includes proper requirements for gathering personal information from borrowers with inadequate financial literacy. This means there is considerable potential for new banking processes to build records able to amplify the deeds registry information.

In the past the South African deeds registry has been regarded as the main custodian of verifiable land information. Properly constructed land tenure records should act as a fortress to protect the rights not only of the financially strong, but of the financially vulnerable too. The anticipated electronification of land registrations under the Deeds Registries Amendment Bill has the potential to improve the cross-referencing of information in future years.[36] Data regarding unregistered rights under the land bills can be therefore be approached with this prospect in mind. The data needs generated by the new bills will include information from the categories

[33] Mwambene and Kruuse lament the fact that by incorporating some common law conventions in the Recognition of Customary Marriages Act, the statute results in a hybrid type of marriage, with elements of both civil and customary law, rather than a specifically customary marriage. See "Form over Function? The Practical Application of the Recognition of Customary Marriages Act 1998 in South Africa" in Claassens and Smythe (eds) *Marriage Land and Custom* 292 295 and 299.

[34] The hybridizing effect of religious influence is evidenced by the fact that of those in the 1996 census who claimed to have been married by traditional rites, 69% defined themselves as Christian. See Budlender, Chobokoane and Simelane "Marriage Patterns in South Africa: Methodological and Substantive Issues" 2004 9 *SAJDem* 1 14.

[35] This is made particularly difficult due to African normative views themselves being in a state of flux and development, as recent research and case law on the living law shows. See Wicomb "Securing Women's Customary Rights in Land: the Fallacy of Institutional Recognition" in Claassens and Smythe (eds) *Marriage Land and Custom* 49-72 and Himonga "Taking the Gap – 'Living Law Land Grabbing' in the Context of Customary Succession Laws in Southern Africa" in Mostert and Bennett (eds) *Pluralism and Development: Studies in Access to Property in Africa* (2011) 114-139.

[36] The Deeds Registries Amendment Bill, 2016 GG 39792 (9-03-2016).

of unregistered rights discussed above. Fulfilling these needs will be a herculean task: a task of such critical importance that the nation must work together towards its success. The banking sector should consider how it could assist the state in this endeavour, in the interest of the sustainability of the deeds registry and the land information system as a whole.

Fair market practices require that banks develop proper processes for borrowers with inadequate financial literacy.[37] Banks collect detailed information relating to potential mortgagors. This information covers issues such as marriage, cohabitation and co-ownership. The Protection of Personal Information Act will lead to tighter controls with regard to the processing of personal information.[38] The Act (which is expected to commence shortly) provides for much more stringent requirements when collecting information. Section 16 stipulates that reasonable steps must be taken to ensure the quality of that information. It must be complete, accurate, not misleading and updated where necessary. In addition, data subjects must be made aware that information on them is being collected, and of the consequences of failure to provide information.[39] Alienated cohabiting partners in unregistered marriages could request confirmation that there is no misleading information regarding their right to property pledged as security.[40] All these considerations and the resulting privacy requirements will need to be taken into account as codes of banking conduct evolve.[41]

Formal land information systems assume that the most important information that needs to be recorded is people's relationship to land, with people's relationship to each other being secondary. There is no publicly accessible database recording the intricate web of relationships that bind people and their dependents to each other. In some countries the emphasis is on relationship lending, with family members as guarantors rather than using property as collateral. It is therefore in the interest of banks to proactively collect information relating to the unregistered rights of partners and dependents when exploring creditworthiness. It would also be appropriate for banks to include simple legal advice in this regard in their processes to address financial literacy. Data highlighting the consequences of marital and cohabiting status (on property rights) and of dependents' right to support (such as the housing duty) is central to the efficacy of the land information system. Any disclosures of this personal information would (in terms of ss 13 and 15 of the Protection of Personal Information Act) have to be compatible with the purpose for which such information was collected. Whether this is broad enough to include a wider identification of people with rights to property held as security remains to be seen. Standard data sharing agreements and consents can be built into customer processes to ensure banks protect against the unlawful dissemination of information and to curtail the contexts in which it may be used. Collecting this information could contribute to protecting certain land tenure rights not adequately reflected in the deeds registry.

[37] National Treasury *Treating Customers Fairly* 10.

[38] Act 4 of 2013.

[39] s 18.

[40] There are, however, limitations on collection of details relating to sex life and children in ss 32 and 34, making the development of codes of conduct in this area necessary.

[41] For an overview of protection of personal information see Giles *Protection of Personal Information Act Summary* https://www.michalsons.com/focus-areas/privacy-and-data-protection/protection-of-personal-information-act (29-09-2016).

Pledges of land as security need not be used merely to protect the bank. They could also be used to trigger a process to protect parties with rights not yet reflected in the formal land information system. This service, being focussed on core customer needs and interests, would indeed go the extra mile in treating vulnerable customers fairly. Land law functions as a process, a process in which banks play a substantial part. When ownership is being transferred (where land was used as collateral) the conveyancing rules require banks to consent to the cancellation of the mortgage bond. Banks are free to refuse consent in appropriate situations. Banking codes can easily insist that updated personal information be requested from customers prior to cancellation. This could go hand in hand with appropriate financial literacy input regarding the legal consequences of changes in household structures. Alternately banks could request that the conveyancer attending to the bond cancellation obtain a certificate from the transferring conveyancer to this effect. Banks are in a very good position to raise the alert timeously if there are unregistered right-holders such as those discussed in this paper.

It is desirable for the banking sector to take a close interest in how land tenure data will be recorded under the new land bills. Understanding the lessons learned in the subsidised housing arena will enable banks to provide services that can enhance protective structures built by the state. A mortgagor's ability to rob a bank of the unregistered rights of their partner and dependents must be curtailed. The state may succeed in securing the protection of these land tenure rights on its own. If not, protection might depend on bank processes. Firstly, banks could ask for clarification of household status. The mortgagor's romantic life might include spouses, mistresses, lovers and/or casual flings, with children born from each of these relationships. Insofar as there is no record of these relationships the rights of these people are invisible. The same applies to requesting information regarding sales of subsidised housing that have never been formally recorded or registered. The banking fraternity should consider posting watchmen to observe the drivers of cars idling close to bank vaults and archives. On the one hand they could sound the alarm for getaway cars ready to rob the bank and drive away with the rights of others. Alternately they could direct drivers to VIP parking when they are bringing important records into the bank for safe custody.

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# Theft by digital means and counterfeit card fraud: a reflection and a look into the future°

GERDA FERREIRA *
DAWIE DE VILLIERS**

**SUMMARY**

Despite payment cards being of a fairly recent origin,[1] these instruments of payment play an increasingly significant role in commerce. With reference to credit cards, Cornelius already stated in 2003: "They fulfil various functions that are increasingly important at a time that e-commerce is taking off at a tremendous pace."[2] Similarly, criminals continuously use more inventive and technologically advanced methods to commit fraud, including counterfeit card fraud and the use of mobile devices. Is the South African criminal law keeping up at the moment and what can we expect from the new Cybercrime and Cybersecurity Bill?[3] The aim of this paper is to investigate whether various activities, with specific reference to bank payment cards, are sufficiently criminalised in South Africa and whether the inability of our criminal law in the past to address the challenges posed by these crimes, will now be rectified by the new proposed legislation.

The first part of the paper refers to the South African common and statutory criminal law, in order to establish whether there was indeed a need for change. The appropriateness of certain statutory provisions is questioned and recommendations are made to amend current legislation.

The second part focusses on broadening the common law crime of theft with reference to defining the subject of theft and examining instances where computers and other digital devices are used to commit the thefts. Two alternative solutions are considered, where one involves a more intense codification process, while the other only develops the common law offence of theft to include incorporeals. This may have an influence on instances like identity theft and the unlawful copying and subsequent use of data.

The third part is an introduction to bank payment card fraud in South Africa and the most prevalent forms thereof, being card-not-present fraud and counterfeit card fraud. Reference is made to the manner in which offences related to counterfeit card fraud are currently approached in our criminal courts and the limited impact prosecutions have on the prevalence of this fraud type.

It is concluded that prosecutions of counterfeit card fraud-related matters could be better facilitated by the introduction of the bill, provided that the relevant role-players are trained, not only in law, but also in the related disciplines. This should result in more convictions and sentences with a deterring impact.

° This contribution is based on Gerda Ferreira *"Counterfeit card fraud: Is there a need to introduce legislation to facilitate the prosecution of related criminal activities?"* (LLM mini dissertation UJ 2012).

* Head of the group forensic services at Nedbank.

** Professor and head of the department of procedural law, University of Johannesburg.

[1] See Otto "Credit card transactions and a spouse's consent in terms of the Matrimonial Properties Act" 1997 *TSAR* 216.

[2] Cornelius "The legal nature of payment by credit card" 2003 *SA Merc LJ* 153.

[3] No less than 20 "new" statutory offences related to cybercrime are proposed in the new Cybercrime and Cybersecurity Bill in chapter 2 and another 21 in the rest of the Bill. A number of these crimes can be linked to some well-known common law crimes such as fraud, theft, forgery, uttering and extortion.



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## 1 *Introduction*

The South African criminal law offers a variety of common law and statutory offences which could be applied to prosecute a number of the broader theft, fraud and related activities attached to credit and debit cards. There is, however, at present, no specific or dedicated legislation in South Africa covering credit card or other payment card schemes.[4] All the criminal activities related to this crime phenomenon are therefore also not currently sufficiently catered for in our criminal law. During his presentation at the opening of the academic year at the University of Port Elizabeth on 3 February 1984 Eksteen argued as follows in favour of the application, and where appropriate the adaptation, of the common law when dealing with technology-driven offences:

> "It seems to me that it is eminently desirable that these novel problems posed by the advent of computers to which I have referred should, so far as is possible, be resolved by the application or adaptation of the principles of our Roman-Dutch law rather than by resorting to legislation which almost invariably presents problems of its own."[5]

As we will argue later, however, the introduction of focused legislation should be considered to criminalise the remaining activities not sufficiently catered for, and to simplify legal principles for more effective prosecution.

## 2 *The relationship between the common law crime of theft and payment cards*

There are various means whereby a sum of money can be appropriated, and the use of negotiable instruments, such as cheques, were for many years commonly used for this purpose. Payment cards, including counterfeit cards, can similarly be used by someone other than the lawful card holder to dispose of a certain sum of money, for which the card holder is then debited by the financial institution who issued the card.[6]

Loubser argues that since a thief can employ a variety of means to steal sums of money,[7] the act of theft, as far as money is concerned, should not be defined in terms of the means employed, but only in terms of the economic effect, and therefore the act must be defined as disposing of, or assuming the power to dispose of, the value or purchasing power represented by a sum of money, resulting in the person entitled to the benefits of such disposal being excluded from those benefits.

Unfortunately, our jurisprudence, until recently, has not yet fully developed to the stage where the copying of data, causing the owner to be deprived of his exclusive right to the property, is considered to constitute an act of appropriation for purposes

[4] Schulze "Of credit cards, unauthorised withdrawals and fraudulent credit-card users" 2005 *SA Merc LJ* 202 210. In the United States card fraud, including counterfeit card fraud, is covered by s 916 of the Electronic Fund Transfer Act of 1978 (15 USC 1693 *et seq*). The United Arab Emirates enacted the Cybercrimes Act, Law no 2 of 2006, which, *inter alia,* prohibits credit card fraud. In this regard see Cassim "Formulating specialised legislation to address the growing spectre of cybercrime: a comparative study" 2009 *PER* 36 53. Although the African Union Commission *Draft African Union Convention on the Establishment of a Credible Legal Framework for Cyber Security in Africa* 2011 contains various provisions aimed at combating cybercrime, including a number of suggested offences specific to information and communication technologies, no recommendations are made specific to payment card fraud. The recommendations include suggestions that the use of information and communication technology to commit common law offences such as theft and fraud should be considered as aggravating circumstances. The convention has not been adopted yet.

[5] "Die bydrae van akademici tot die regspleging" 1984 *Obiter* 1 4.

[6] In such cases the offender's conduct will usually also involve fraud and s/he will thus not necessarily be charged with theft.

[7] Loubser *The Theft of Money in South African Law* (Thesis Oxford 1977) 139.

of satisfying that element of the common law crime of theft.[8] The definition of appropriation, as still currently interpreted by some members of the judiciary and by academia, does not clearly cater for the phenomena (and increasing threat) of identity theft and theft of data found in modern society and business. The essence of these criminal activities is that the owner at all times remains in possession of the incorporeal assets, which are copied for the intrinsic value thereof for the facilitation of various subsequent dishonesty-related offences. Whilst the owner is not immediately deprived of the ability to exercise related rights, the criminal obtains a similar "right" (ability) which is exercised simultaneously and to the prejudice of the owner, often leading to the owner subsequently being excluded from the benefits of those rights, due to the eradication of whatever credit facilities the owner had.

When data on the magnetic strip or microchip of a payment card is, for instance, "stolen" or personal-card data is "stolen" *via* hacking[9] or phishing[10] to facilitate the manufacturing of a counterfeit payment card intended for use in card-not-present fraud, proving the element of appropriation in its current definition could be problematic. That is because the data is in reality only copied to provide the perpetrators with the ability to access and steal the money and/or credit of the owner of the original payment card. The owner is thus not deprived of his property (the card and information encoded on it) and neither is he excluded from exercising his rights in respect of that property (the credit in the account to which the card grants access). It is his rights in respect of that property (both the data on the card and the funds in the account) that are simultaneously being infringed upon by the perpetrator. However, due to the use thereof by criminals in possession of counterfeit payment cards, the legitimate owner of such a card would in most cases be deprived of the use of the property soon after the track date and personal information number (PIN) of his card were compromised due to the funds or credit being exhausted.[11] Although the owner is thus not deprived of control over his card, the activity by the fraudsters ultimately causes him to lose control over the funds and facilities for which he had used his card as an instrument to gain access and use.

Predominantly due to the development of technology, the true nature of the act of theft in modern society has changed and there has been for a long time a dire need for our common law of theft to be developed accordingly. Actual physical handling of the object is not always essential for the "thief" to achieve all the benefits traditionally associated with the completed crime of theft. Thus, to satisfy the requirements of the crime of theft in a modern society, obtaining control over the property and depriving the owner from exercising his related rights, should not be essential requirements. Similarly, as a book entry to the financial prejudice of a complainant may amount to theft of the money involved, copying data unlawfully

[8] Watney "Die strafregtelike en prosedurele middele ter bekamping van kubermisdaad (deel 1)" 2003 *TSAR* 56 60.

[9] "Hacking" can be described as unauthorised access to a computer.

[10] "Phishing" entails sending out an email purporting to require information from the recipients for some legitimate purpose. "Phishing" has been explained as follows by Van der Bijl "SIM-card swapping, mobile phone banking fraud and RICA 70 of 2002" 2009 *SA Merc LJ* 159 161: "Phishing entails that unsolicited e-mails, purportedly from the bank, are sent to clients requesting them to update and verify details such as their PIN ('Personal Identification Number'), password, cellular phone number and address. The client will then be requested to click on a link and update his personal details. Once the link is clicked on, the client is diverted to a fraudulent website. The fraudsters then gain access to the client's personal details and cellular phone number when the client responds to such phishing e-mails."

[11] For a discussion of ways in which the PIN of payment cards is compromised, see par 5.4.2 below.

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or assuming another person's identity for own future use ought to amount to theft.[12] The act of "appropriation" involved in the modern variation of theft will often be virtually inseparable from the element of intention and the act has to be coloured by the requisite intention for theft to be proven.

### 2.1 The appropriation act and meaning of property (things capable of being stolen)

Because of the element of *contrectatio* in Roman and Roman-Dutch law, any item of property that did not have an actual physical existence could not be stolen and only corporeal movable things were thus capable of being stolen.[13] Loubser correctly argued that the law of theft in South Africa could not only apply to money in the form of notes and coins or cheques, which is corporeal, but that it had to provide for the unlawful appropriation of credit or of an incorporeal sum of money.[14] His inference was based on the following argument:

> "The underlying reason why the criminal law cannot confine itself to the unlawful appropriation of money in corporeal form is because money, whether in the form of banknotes and coins or in the form of credit, essentially represents a certain intrinsic value or purchasing power, and where a person is unlawfully deprived of the benefits of disposing of this value or purchasing power it makes no difference economically whether this occurred through a loss of banknotes and coins or through a reduction of the credit in his bank account."[15]

Burchell also points out the importance of the commercial and mercantile implications of the proposition that in South African law only corporeal things are capable of being stolen for a modern system of banking where most transactions are dealt with by way of entries in books of accounts, cheques, credit cards, automatic teller machines and electronic transfers.[16] Such a construction would be untenable. The relative wealth of the owners of the respective accounts is impacted upon by the entry of debits and credits in the books of account and money is transferred as incorporeal credits in the books of account.

The South African courts have gradually abandoned the common-law requirement of a corporeal object and have accepted that theft of money cannot be restricted to money in corporeal form. In *Manuel* Greenberg JA explained his finding that the accused had stolen the complainant's money as follows: "under our modern system of banking and paying by cheque or kindred process, the question of ownership in specific coins no longer arises in cases where resort to that system is made". [17] Moreover, as early as in 1955, Van den Heever JA made the following *obiter* remark: "nowadays in cases of theft we are apt to look at the economic effect of the act by which a person fraudulently converts money to his own use rather than be hypnotised by the concrete mechanics by means of which the crime is committed."[18]

The Appellate Division recognised the fact that an incorporeal sum of money could be the object of theft in a number of cases, including *Scoulides*[19]and

[12] See par 2.4 below for further discussion of identity theft.
[13] Burchell *Principles of Criminal Law* (2005) 788.
[14] (n 7) 107.
[15] Loubser (n 7) 107- 108.
[16] Burchell (n 13) 789.
[17] 1953 4 SA 523 (A) 526H.
[18] *Sibiya* 1955 4 SA 247 (A) 261 referring to *Solomon* 1953 4 SA 518 (A).
[19] 1956 2 SA 388 (A).

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*Gathercole*.[20] In *Graham*[21] the court held that where theft of a sum of money and theft of a cheque for that sum were charged alternatively, the conviction could be upheld on either of these charges. In *Kimmich*[22] it was held that the accused not only appropriated the cheques as corporeal objects, but also the proceeds or economic value that the cheque represents, which is incorporeal in nature:

> "Although in terms of the Roman-Dutch law only corporeal things are capable of being stolen (see *S v Graham* (*supra* at 576E)) our Courts have expanded the concept of theft, in respect of money other than physical notes and coins, and have held that a conviction of theft of an incorporeal in the form of (a) a diminution of a credit balance in a complainant's bank account (see *S v Kotze* (supra)); and (b) the appropriation of the proceeds of a cheque (see *S v Visagie* 1991 (1) SA 177 (A); *S v Graham* (supra at 577B)) is competent in our law. Our Courts furthermore do not appear to have had any difficulty in holding that other incorporeals, such as shares, in contra-distinction to share certificates, are capable of being stolen (see *S v Harper and Another* 1981(2) SA 638 (D) at 664G – 668H)."

Since money in an incorporeal form can be stolen, it follows that money in its credit form can also be stolen. It will thus not only constitute theft to deposit a cheque drawn fraudulently on another person's bank account, or to instruct a computer to transfer money from one account (without the account holder's knowledge and permission) to another account, but also if a counterfeit card is used at an automatic teller machine to draw money from the legitimate card holder's account. For a strange outcome of why the accused is not guilty of the theft of trust money see *Moolman*.[23]

The Roman-Dutch law's contention that only corporeal things are capable of being stolen also provided our courts with a number of difficulties.[24] In *Mintoor*[25] it was stated that there could be no theft of electricity or other forms of energy. Copying of computer software programmes would also fall outside the definition of theft.[26] The theft of electricity once again became an issue in *Ndebele.*[27] The court took an opposing view and decided that electricity can actually be stolen[28]. However, data and information are not at the moment legally recognised as

[20] 1964 1 SA 21 (A).

[21] 1975 3 SA 569 (A) 575H-576D. For a discussion of the case and related matters see Dreyer "Computer law in South Africa" 1983 *De Rebus* 534 536 and 537. Also see *Kotze* 1965 1 SA 118 (A) where the Appellate Division concluded that since a valid cheque represents money and is a generally acceptable form of payment, an agent commits theft of a sum of money if he receives cheques for payment of debts owed to his principal and deposits the cheques in payment of his own private debts, instead of applying them for investment on behalf of his principal. Loubser (n7) 120 criticises this finding and correctly points out that a negotiable instrument like a cheque does not represent money, but embodies a certain right to money.

[22] 1996 2 SACR 200 (C) 210e.

[23] 2006 1 SACR 432 (T).

[24] Coetzee "Diefstal van onliggaamlike sake" 1970 *THRHR* 369; Van der Merwe "Computer crime" 1983 *Obiter* 124; Skeen "Computers and crime" 1984 *SACC* 262; Van der Merwe "Diefstal van onliggaamlike sake met spesifieke verwysing na rekenaars" 1985 *SACC* 129

[25] 1996 1 SACR 514 (C).

[26] Skeen (n 24) and Van der Merwe (1985) (n 24).

[27] 2012 1 SACR 245 (GSJ).

[28] Snyman *Criminal Law* (2014) 482 – 483 does not support the decision and Jordaan "Theft – act of appropriation – electricity" 2012 *SACJ* 314 – 316 is also concerned about the consequences of the decision. For a supporting view of the decision see D'Oliviera "Theft of electricity: A short circuit?– *S v Ndebele* 2012 1 SACR 245 (GSJ)" 2012 *THRHR* 312.

property and can thus not be stolen, despite being potentially very valuable.[29] Van der Merwe profoundly stated:

> "'data' is the real gold ore which needs to be processed intelligently in order to lead to higher forms of information value. For this reason the South African criminal law system urgently needed to formulate crimes which would protect the integrity and inviolability of data, particularly because our criminal law historically focused on protecting intangible assets and money. Any criminal law system which fails to adequately protect one of the most valuable commercial resources, will ultimately fail in its purpose."[30]

Section 15 of the Cybercrime and Cybersecurity Bill 2016, now explicitly makes provision for the theft of the data obtained from a card.[31]

### 2.2 Unlawfulness as prerequisite for theft

The appropriation of money will generally be unlawful when the person appropriating the money is not in law entitled to that money. It is difficult to think of any possible grounds of justification if a person's money or credit is stolen through the use of a counterfeit card and such conduct would in my view always be considered unlawful.

The theft of a single payment card is sometimes considered to be so trivial that the *de minimis* rule is invoked as grounds not to prosecute.[32] The Appellate Division has confirmed that this rule is applicable to the crime of theft in appropriate circumstances, since the courts "should not be concerned with such trivialities".[33] This view may be justified if the potential and likely use thereof in cases concerning card-not-present and/or counterfeit card fraud is ignored. Although it should not be difficult to prove the value and potential for fraudulent use of such a stolen card, it may be challenging to convince a court beyond reasonable doubt that the thief had such fraudulent use in mind. Since there is no other obvious reason why somebody would steal a payment card, the court could, however, be requested to accept such an objective as the only reasonable inference in the circumstances once the actual theft of the card has been proven.

In such cases the decision in *Nedzamba*[34] should be followed, where the court correctly refused to invoke the *de minimis* principle in a case where the accused stole two blank cheque forms. The court considered not only the commercial value of the unused cheque forms, but also the motive of the thief in stealing the article, the effect of the deed on the community, and all the circumstances in which the deed was committed. In *Murbane*[35] the court also considered the argument that a cheque form has no value and that the *de minimis non curat lex* principle should be applied and, emphasising the potential fraud that could be committed using

[29] For a discussion of this *lacuna* and possible solutions see Coetzee (n 24) 369; Van der Merwe (n 24) 130 *et seq*; Kleyn "Dogmatiese probleme rakende die rol van onstoflike sake in die sakereg" 1993 *De Jure* 3 ff and Maat "Cyber crime a comparative law study" (Thesis Unisa 2004) 192 ff.

[30] "Information technology crime – a new paradigm is needed" 2007 *THRHR* 309 312.

[31] It reads: "The common law offence of theft must be interpreted so as not to exclude the theft of an incorporeal."

[32] The *de minimus non curat lex* rule means that a crime may be so insignificant in nature that the law may disregard it as too trivial to warrant criminal liability. For a discussion of this principle see Burchell (n 13) and Labuschagne "*De minimis non curat lex* as strafregtelike verweer in'n regstaat: opmerkinge oor strafsinvolheid en die groeiende rasionele dimensie van geregtigheid" 2003 *THRHR* 455.

[33] See *Kgogong* 1980 3 SA 600 (A) 603H.

[34] 1993 1 SACR 673 (V) 676.

[35] 1992 1 SACR 298 (NC).

a stolen cheque form, held that the argument held no merit. Buys J commented as follows:[36] "Dit sal tot totale chaos in die handelswêreld lei as die diefstal van tjekboeke en tjekblaaie nie as 'n misdaad beskou word nie."[37] With reference to the above cases, the court should consider the special nature of a payment card, the purpose for which it is used in the commercial world, and the impact of payment-card fraud when determining whether the application of the *de minimis* rule will have an adverse impact on the interests of the community.

### 2.3 Intent to steal

The form of culpability required for theft is intention. The accused must intentionally effect an appropriation; must intend to deprive the owner permanently of his property or control over his property; must know that the property is capable of being stolen; and must know that he is acting unlawfully in taking it.[38] The Appellate Division further held that an accused cannot be convicted of theft unless he intends to deprive the owner permanently of the whole benefit of his ownership.[39]

When property such as a vehicle is removed from the owner's control for temporary use, but with the intention of returning it to the owner at a later stage, the temporary borrowing of the property without the authorisation of the owner thereof will not constitute theft. The legislature attempted to fill the gap in our law by creating a statutory offence to criminalise the removal of property for use.[40]

If a person picks up lost property, the act of picking up the property does not constitute unlawful taking and does not give rise to the presumption that there was an intention to terminate the owner's enjoyment of his rights. On a subsequent charge of theft, the *onus* remains on the state to prove the *animus furandi*.[41]

Theft can never be committed negligently. Intent in the form of *dolus eventualis* will suffice. *Dolus eventualis* exists "where the accused does not 'mean' to bring about the unlawful circumstance or to cause the unlawful consequence which follows from his or her conduct, but foresees the possibility of the circumstance existing or the consequence ensuing and proceeds with his or her conduct".[42]

When the data contained on the magnetic strip or microchip of a payment card is copied, the owner is not permanently deprived of the relevant information. In such a case the owner will no longer have exclusive use of the data. Ebersöhn argued that in the instance of mere copying of electronic data, the perpetrator appropriates the immaterial property rights of the owner of the data, has the intention to exercise ownership rights over the electronic copy of the original data, and, although he has the intention to deprive the owner of his control over the data temporarily and not permanently, such conduct should qualify for the offence of theft.[43] He argues as follows:

[36] *Murbane* 1992 1 SACR 298 (NC) 301.
[37] Our translation: It would lead to complete chaos in the business world if the theft of cheque books and cheque pages is not considered a crime.
[38] Burchell (n 13) 792 and *Boesak* 2000 1 SACR 633 (SCA) 659 par 97.
[39] *Sibiya* (n18) 257; *Van Coller* 1970 1 SA 417 AD 424G – 426A; *Heller* 1971 2 SA 29 (A) 46 and *Macrae v S* [2014] ZASCA 37 (28 March 2014).
[40] s 1(1) of the General Law Amendment Act 50 of 1956. Since one of the requirements of s 1(1) is the removal of property from the control of the owner, it will also not be applicable to the copying of data on a bank payment card when a skimming device is used.
[41] *Luther* 1962 3 SA 506 (A).
[42] Burchell (n 13) 462. For a comprehensive discussion of the various forms of intention see Burchell (n 13) 461 ff.
[43] Ebersöhn "A common law perspective on computer-related crimes (1)" 2004 *THRHR* 22 37 – 41.

> "It is submitted that our courts should give effect to the economic reality and hold that the intention to temporarily deprive the owner of the benefits of his ownership rights (control) by making an electronic copy and the intention to exercise control over the electronic copy suffices for the purposes of theft."[44]

However, this view has not been supported by all our courts.[45] Maat recommended intervention by the legislature and the enactment of a provision in respect of the intentional and unlawful use or copying of data and certain information without authority.[46] She suggested the following text: "A person who intentionally and without authority copies or uses protected data, is guilty of an offence." This is now being dealt with in the Cybercrime and Cybersecurity Bill. Section 2(1) creates the first offence where a person secures access to data, a computer program, data storage medium, or computer system, and section 2(2) explains what constitutes "secures access". Subsections 3(1) and (2) makes it a crime to unlawfully and intentionally acquire or possess protected data, while subsection 3(3) criminalises being found in possession of protected data if there is a reasonable suspicion that such protected data was acquired and the person is unable to give a satisfactory, exculpatory account of such possession.

If a person uses a counterfeit card either at an automated teller machine (ATM) to withdraw money from the account of the legitimate owner of the originally issued payment card, or to pay for merchandise, he will be guilty of theft.[47] The unlawful access, copying and subsequent use of data to manufacture counterfeit cards, however, do not meet the requirements of the common-law offence of theft,[48] although this is now covered by section 4(1) of the mentioned Bill. This section covers a number of acts[49] related to software or hardware tools and it qualifies the acts with "the purposes of contravening certain provisions of the Bill".

### 2.4 Identity theft

Watney defines identity theft as "the abuse of personal information to impersonate somebody else with the intent to commit a crime, for example the use of another's banking facilities without the consent of the account holder".[50] This type of theft is predominantly commissioned through fraud, often in the form of social engineering,[51] phishing or spoofing.[52] Counterfeit card activity is a fine example of identity theft. Although identity theft is not a new threat, the electronic environment makes it significantly easier to access the personal information required to commit

[44] Ebersöhn (n 43) 38.
[45] See *Sibiya* (n 18).
[46] Maat (n 29) 201.
[47] See par 5 below.
[48] See par 2 above.
[49] The acts are "manufactures, assembles, obtains, sells, purchases, makes available, possesses or advertises" the software or hardware tools.
[50] Watney "Identity theft – the dangerous imposter" 2004 *De Rebus* 20.
[51] "Social engineering" is the term used to describe where the fraudster engages in social contact with the victim to extract personal or confidential information required to facilitate the planned criminal activity. For examples of this see Augustyn "Identity theft escalation – you may need to change your life" 2005 *South African Journal of Information Management* 1 6.
[52] "Spoofing" in this context takes place when the link to a website in an email seems legitimate, while the underlying hyperlink is to a completely different site used to lure users to provide their personal details under false pretences. Other methods of obtaining the personal information of other persons include interception of mail and retrieving documents from rubbish bins.

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this offence.[53] As stated by Atta-Asamoah, "a more complex form of cybercrime has emerged in which cyber criminals focus primarily on assuming the identity of the target. These second-generation types of crimes make extensive use of information technology skills and involve less time".[54]

At present the South African criminal law does not provide for the prosecution of this crime phenomenon. Identity theft does not fall within the existing definition of theft, for two reasons: the "identity in the form of personal information relevant to a specific person is not tangible and the owner of that identity is not permanently deprived of his or her identity when utilised by another person".[55] The Electronic Communications and Transactions Act[56] also does not specifically provide for the criminalisation of identity theft.[57]

Watney's view that the prosecution of these offences did not pose a problem is not fully supported.[58] The electronic accessing of the relevant personal data is likely to constitute a statutory offence if proven,[59] and the use of such "stolen identity" will constitute fraud and may constitute theft of money. However, a person who is caught copying personal data related to the identity of another or is unlawfully found in possession of the personal information of other persons, either in the form of the "raw data", for example a stolen database in its original format, or in the form of an instrument of crime, such as a counterfeit card or cloned cheque, may at the moment go unpunished.[60]

It is our submission that identity theft is now covered by section 7(1) of the Cybercrime and Cybersecurity Bill. It covers the acquiring, possession, providing and use of passwords, access codes or similar data or devices.[61] Subsection 7(2) is concerned with a person found in possession of an access code, password or similar data or device and can be compared to subsection 3(3) above, where it refers to the reasonable suspicion and the inability to give satisfactory exculpatory account of such possession.

### 2.5 *Attempted theft*

It is common cause that attempts to commit common law crimes and statutory offences are punishable. In *Agliotti*[62] it was held that a person is guilty of attempting to commit a crime if, intending to commit that crime, he unlawfully engages in conduct that is not merely preparatory but has reached at least the commencement of the

[53] Watney "'Identity theft': the mirror reflects another face" 2004 *TSAR* 511.
[54] "Understanding the West African cyber crime process" 2009 *Institute of Security Studies African Security Review* 106 109.
[55] Watney (n 53) 512.
[56] 25 of 2002 (ECT Act).
[57] See par 4.1.1 below for a discussion of the ECT Act. Le Roux in "Diefstal deur middel van die rekenaar" 1985 *De Rebus* 401, argued in favour of legislation to cater for new crime types created by the use of computers, including theft of information.
[58] Watney (n 53) 513 and 518.
[59] It is likely to be a contravention of s 86 of the ECT Act. See par 4.1.1 below.
[60] This will not be the case if the facts support a prosecution relying on the doctrine of common purpose. See Matzukis "The nature and scope of common purpose" 1988 *SACJ* 226. If the data is copied by means of a handheld skimming device a prosecution under the ECT Act may not succeed as explained in par 4.1.1 below.
[61] Section 6(2) provides a wide meaning of "password, access code or similar data or device".
[62] 2011 2 SACR 437 (GSJ) par 10.2.

execution of the intended crime.[63] A statutory provision[64] with general application to all statutory offences also makes attempt punishable. In *Mekula*[65] it was said:

> "Because of the vagueness of the test employed to determine punishable attempt, the punishment of incomplete attempts raises constitutional issues of legality, particularly the issue of fair warning and the principle of certainty (the *ius certum* principle). Be that as it may, in terms of criminal law doctrine, punishment for conduct which is harmful to society and also conduct which is *potentially* harmful to society are justified."

Where we assume that the objective of a syndicate employing a skimming device[66] is to use the track data[67] copied from it to produce counterfeit payment cards with the ultimate objective of using such newly created cards to steal the money and/or credit of the original card holder, the question arises whether the perpetrators involved in the entire process could successfully be prosecuted for attempted theft. This may be based on evidence that they were already in the process of committing acts indicating that they have appropriated for themselves the rights of the owner.

In *B* Schreiner JA held that the test is whether "the accused had already commenced the consummation of the act constituting the offence or had only taken steps leading up to the stage of commencing to carry it out".[68] The appropriate approach was defined by Watermeyer CJ as follows:

> "The time when the consummation begins must necessarily vary with the particular crime and depend upon the circumstances of the particular case. There are, however, certain general considerations which may legitimately be regarded as of assistance in the solution of the problem. One of these is that the question whether or not a man's wrongful conduct should, in law, be regarded as criminal or innocent should not depend entirely upon the time at which an event happens, when such a time may be largely determined by chance. Consequently if a wrongdoer has finally made up his mind to commit a crime and has taken steps to carry out his resolution, the exact moment at which he is interrupted and prevented from fulfilling his intention should not be the sole determining factor in deciding whether his morally wrongful act should be regarded as a crime. Provided always that his acts have reached such a stage that it can properly be inferred that his mind was finally made up to carry through his evil purpose he deserves to be punished because, from a moral point of view, the evil character of his acts and from a social point of view the potentiality of harm in them are the same, whether such interruption takes place soon thereafter or later. Consequently the Court should lean towards giving a wide interpretation to the phrase 'commencement of the consummation' by including in such consummation all the last series of acts which would constitute a continuous operation, unbroken by intervals of time which might give an opportunity for reconsideration."[69]

In *Sibuyi*[70] the court held that a theftuous intention without any physical expression cannot amount to theft or attempted theft. The state has to prove that the accused had intent to commit theft and that he acted in furtherance of that intent. A person found in possession of counterfeit cards aimed at being used at some time in the future to steal the money available in the legitimate cardholder's account, has not

[63] We cannot agree with the suggestion in *Nkosi* 2012 1 SACR 87 (GNP) that theft from a self-service shop should be treated as a "special form of theft".

[64] According to section 18(1) of the Riotous Assemblies Act "any person: who attempts to commit any offence against a statute or a statutory regulation shall be guilty of an offence".

[65] 2012 2 SACR 521 (ECG)

[66] For a discussion of skimming devices see par 5 below.

[67] For a discussion of track data see par 5.

[68] 1958 1 SA 199 (A) 202E.

[69] *Schoombie* 1945 AD 541 547 as quoted and affirmed in *B* (n 68).

[70] 1993 1 SACR 235 (A) 241H – J.

yet commenced the consummation of the crime and can thus not at present be convicted of attempted theft. The mere acquisition or manufacturing of a card with the intent to commit theft or fraud does not amount to attempted theft or fraud. However, it will be possible under the new Cybercrime and Cybersecurity Bill to charge such a person for contravening section 7(1) or 7(2).[71]

### 3 *The relationship between the common-law crime of fraud and payment cards*

Fraud is the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another.[72] Burchell summarises that various forms of deception, swindling and trickery are in the South African law embraced in the single crime of fraud which penalises any misrepresentation that causes another to suffer some form of prejudice.[73] Due to the fact that potential prejudice suffices, the offence of attempted fraud only exists in a few scenarios, such as when a misrepresentation is made but never communicated.[74] Henning J summarised the legal position as follows:

> "One would look at the mind of the deceiver and, once he has been proved to have gone beyond acts of preparation in making a fraudulent misrepresentation intended to be acted upon, he would be guilty of an attempt to defraud, and he would likewise be guilty and his conduct punishable if thereafter his design is frustrated for whatever reason….once a false representation is proved to have been wilfully made with intention to deceive, and to be acted upon by the representee to his actual or potential prejudice, the crime of fraud has been established; if the representation has not yet been communicated to the mind of the representee, a verdict of an attempt to commit fraud might be proper."[75]

### 3.1 Conduct (misrepresentation)

The misleading or attempted misleading of the victim of fraud by way of a misrepresentation is the essence of the crime. Although the misrepresentation usually takes the form of written or spoken words, it is also often made by conduct.[76] The definition of fraud is therefore broad and the persons affected by fraud can be very wide. Non-disclosure in the face of a duty to speak may constitute criminal fraud even if the failure to comply with that duty is not visited with a criminal

[71] See the discussion under par 2.4 above.
[72] Snyman (n 28) 523. See also *Gardener* 2011 4 SA 79 (SCA) 86 par 29; *Malan* 2013 2 SACR 655 (WCC) 660 par 7. and *Essop* 2014 2 SACR 495 (KZP) 513 par 37.
[73] Burchell (n 13) 833.
[74] *Heyne* 1965 3 SA 604 (A). An example of attempted fraud would be when the letter containing the misrepresentation was never delivered, due to getting lost or intercepted in the post as the case was in *Isaacs* 1968 2 SA 187 (D). See also *Francis* 1981 1 SA 230 (ZA); *Moodie* 1983 1 SA 1161 (C) and a discussion of the issue in Burchell "Does potential prejudice suffice for fraud?" 1963 *SALJ* 168.
[75] *Isaacs* (n 74) 191A – C.
[76] *Larkins* 1934 AD 91 94 and *Mbokazi* 1998 1 SACR 438 (N) 445F – I.

sanction.[77] There is also authority for the proposition that a representation "to the world" may constitute criminal fraud.[78]

The mere handing over of a counterfeit payment card as instrument to pay for goods or services at a merchant,[79] or the use thereof at an ATM to draw money, or the capturing of its particulars to effect payment of goods on the internet will constitute the misrepresentation required. Botha, in our view incorrectly, argued that fraud cannot be committed by way of an automated teller machine as it is not possible to make a misrepresentation to a machine.[80] The misrepresentation is in fact made to the bank, or more specifically a banker, as was argued by Burchell with reference to the judgment by Boshoff JP in *Myeza*[81] where a parking meter was activated by using a beer-can ring instead of a coin:

> "On this reasoning it would follow that persons who withdraw money from automated teller machines (ATM) in banks by misrepresenting their identity could be convicted of fraud. Since an ATM is nothing but a computer linked to the funds and records of the bank and serves as a conduit for transmitting instructions as to the receiving or withdrawing of funds, the misrepresentation involved is made to the banker."[82]

With reference to the *Myeza* case[83] the writers Carstens and Trichardt argue:

> "…the element of misrepresentation with regard to the crime of fraud, in cases of computer crimes by means of the ATM, lies therein that the perpetrator unlawfully and fraudulently represents to the bank by means of his actions channelled through the ATM, that he has sufficient funds, or made sufficient deposits or transfers enabling him to withdraw money. The perpetrator is thus misrepresenting results on his account, results produced by means of the ATM and herein lies the misrepresentation to the bank, inducing the bank to believe that the results were lawfully produced by means of information channelled through the ATM and that he (the perpetrator) is now entitled to withdraw money. It is further submitted that, just as the element of misrepresentation in this case was not considered to be a misrepresentation made to a parking meter, the same argument is valid in the case where money is fraudulently withdrawn, transferred or deposited by means of an ATM, that the misrepresentation is made to the bank and not to the computer."[84]

[77] *DPP Western Cape v Malan* 2014 (2) SACR 146 (WCC) par 23.

[78] In *Mdantile* 2011 2 SACR 142 (FB) the accused was charged with fraud. He went to a train station but walked past the ticket-sales office. He proceeded straight to the platform security gate, manned by a security guard. At that checkpoint, only passengers with tickets were allowed to go through onto the platform. He gave the security guard R20 to allow him onto the platform, as if he were the holder of a valid train ticket, and boarded a train. On the train a ticket examiner asked to see his ticket, which he could not produce. He was arrested and charged with fraud. The court held that if a deceiver intends to defraud and his behaviour and actions are consistent with that intention, it is immaterial whether the false representation was manifested to a specific person by way of an explicit or implicit distortion of the truth. In giving the security guard R20 and causing the security gate to be opened, the accused represented to the world that he had a valid ticket, knowing that that representation was false. Rampai J mentioned: "If the deceiver candidly intended to defraud, as in this instance, and his behaviour or actions are consistent with his pervasive design, it becomes immaterial whether the false representation was manifested to a specific representee by way of an explicit or implicit distortion of the truth – sometimes called positive misrepresentation, or negative misrepresentation, respectively." (Par 34.)

[79] *Salcedo* 2003 1 SACR 324 (SCA). Botha "Bedrog ten opsigte van die gebruik van tjek- en/of kredietkaarte" 1988 *SACJ* 377 383 expresses the view that such fraud is committed in writing due to the fact that the perpetrator has to forge the signature of the legitimate card holder.

[80] "Sogenaamde 'rekenaarbedrog'" 1990 *SACJ* 231. See also *Narlis v South African Bank of Athens* 1976 2 SA 573 (A) 577 where the court held that a computer is not a person.

[81] 1985 4 SA 30 (T). For a discussion of the case see Botha "*S v Myeza* 1985 (4) SA 30 (T): oor blikringetjies en boetebessies – aspekte van bedrog" 1986 *SACJ* 72.

[82] Burchell (n 13) 840.

[83] (n 81).

[84] "Computer crime by means of the automated teller machine – just another face of fraud" 1987 *SACJ* 122.

This view is also supported by *Van den Berg*[85] where a misrepresentation electronically introduced into the computer system resulting in an account falsely being credited, was held to constitute a misrepresentation to the bank, being a legal *persona*.[86] When cash is withdrawn at an ATM with a counterfeit card, the implied representation to the bank would be that it is the customer withdrawing the money or that the transaction has been duly authorised by the customer.[87] It is not a requirement that the charge sheet alleges that the misrepresentation was made to a specific person.[88]

The misrepresentation could either be explicit or implicit. When a counterfeit card is used to pay a merchant for goods or services and the fraudster falsely places what purportedly is the legitimate card holder's signature on the payslip, the fraudster implies that he is the authorised card holder and is entitled to present the card for payment, and he therefore commits fraud. The situation is similar when somebody else's particulars (those of the lawful card holder) are being provided to a merchant to conduct a card-not-present fraud.

### 3.2 Unlawfulness

Although there are generally various grounds of justification to be raised on a charge of fraud, such as compulsion, obeying orders and consent, the use of a counterfeit card as an instrument to effect payment or obtain cash is clearly against the *boni mores* and therefore on face value unlawful.[89]

### 3.3 Intent to deceive and the intent to defraud

Intent to defraud has two principal aspects: intention to deceive and intention to induce a person to alter or abstain from altering his or her legal position. The *locus classicus*, as regard to intent to deceive, is *Derry v Peek.*[90] The fraudster must have both the intent to deceive and the intent to defraud. He must thus make the representation knowing or foreseeing that it might be false. Stegmann J confirms that intent in the form of *dolus eventualis* will suffice and defines it as follows:

> "… when one person makes a representation of fact to another whilst not knowing whether his representation is true or false, if the representor knows that his representation may be false and reconciles himself to the risk entailed in suggesting it to be true, to the potential or actual prejudice of that other or of anyone else."[91]

The distinction between an intention to deceive and an intention to defraud was clarified as follows by Buckley J in *Re London and Globe Finance Corporation*

[85] 1991 1 SACR 104 (T)
[86] (n 85).
[87] *Mbokazi* (n 76) 445F – 446C.
[88] *Avion Motor Enterprises* 1987 4 SA 692 (T).
[89] For a discussion of unlawfulness as an element and grounds of justification, see Burchell (n 13) 835 – 836 and Snyman (n 28) 539.
[90] (1889) 14 App Cas 337 at 374, in which Lord Herschell said that: "(F)raud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second I and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states." This case was once again recently referred to in *Ndwambi* 2016 2 SACR 195 (SCA) par 14. The long and well-written dissenting judgment in *Nwambi* by Willis JA where he disagreed with the finding of Meyer AJA (and three concurring judges) is proof of the complex nature of the intent to defraud.
[91] *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 T 101 D.

*Ltd*: "To deceive is by falsehood to induce a state of mind; to defraud is by deceit to induce a course of action."[92] Heher JA in *Gardener* made the following *obiter* remark in this regard:

> "The authorities I have cited support the view that an intention to cause actual or potential prejudice is a necessary element of the crime of fraud. But it may be that proof of deceit which is calculated (likely), in the ordinary course of things, to result in such prejudice is sufficient, without a subjective mental element."[93]

The state could only rely on this if the representation pertained to an objectively ascertainable fact and not when it related to the accused's state of mind.[94] This provision was, however, found to compromise the right to be presumed innocent severely and thus a court can no longer rely on it.

It is difficult to imagine circumstances in which the user of a counterfeit card would not be making the misrepresentation knowingly or would make it without the intent to defraud. Even in instances where a counterfeit payment card is presented at a so-called "friendly merchant" who provides the fraudster with the merchandise or even cash, knowing that the card being presented for payment is a counterfeit card, fraud has still been committed, since the law only considers the state of mind of the deceiver and not that of the person to whom the misrepresentation is made.[95]

### 3.4 Prejudice (actual or potential)

The crime is only punishable if the misrepresentation brings about actual or potential prejudice of a proprietary (financial) or non-proprietary nature.[96] Prejudice of a non-proprietary nature would, for instance, include damage or potential damage to the reputation of a bank whose automated teller machines are continuously targeted by the use of high-technology skimming devices,[97] the risk of negative media publicity and the risk of loss of credibility in the security of ATM transactions.[98]

"Potential" prejudice means that the making of the misrepresentation objectively involved a risk of prejudice and the test is whether it was reasonably possible that prejudice would occur.[99] Although the risk of harm should not be too "remote or fanciful", the test is an objective one and it is not necessary to prove that the prejudice was probable.[100] It is thus not relevant that the victim was not misled by the misrepresentation.[101] Negligence on the part of the representee also does not assist the representor.[102]

92 [1903] 1 Ch 728 at 733 as quoted and approved in *Isaacs* (n 74) 191H. See also Makakaba "Rubber cheques" 2007 *JBL* 17 19.

93 *Gardener* (n 72) 87 par 32.

94 *Van Niekerk* 1981 3 SA 787 (T) 790 and *Harper* 1981 2 SA 638 (D) 649.

95 *Judin* 1969 4 SA 425 (A).

96 *Dyonta* 1935 AD 52 55 – 56 and *Myeza* (n 81) 32. Also see *Ressel* 1968 4 SA 224 (A) 232 E – G. For a discussion of the wide sense in which courts have interpreted "prejudice" see Ebersöhn "A common law perspective on computer-related crimes (2)" 2004 *THRHR* 193 193 – 196. See also *Tshopo* 2013 1 SACR 127 (FB) 130 par 7.

97 Colloquially referred to as "high-tech skimming devices or high-tech skimmers".

98 Prejudice in the form of the risk of dishonour or loss of reputation was already acknowledged in *Seabe* 1927 AD 28 33.

99 *Seabe* (n 98) 32 and *Kruger* 1961 4 SA 816 (A) 828H – 829A. It is not necessary to prove a probability of prejudice; a possibility of prejudice will suffice.

100 *Heyne* (n 74) 622 E – 623 A.

101 See *Dyonta* (n 96) and *African Bank of SA Ltd* 1990 2 SACR 585 (W) 647F.

102 *African Bank of SA* (n 101) 647F.

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The prejudice could be suffered by a third party. This will usually be the case when a counterfeit payment card is used, since the misrepresentation will usually be made to a merchant or a bank, whilst the holder of the targeted account, and the legitimately issued payment card, will suffer the prejudice or potential prejudice if the fraud was detected before the money left the account.[103]

Despite criticism that the concept of potential prejudice creates an excessively wide scope to the South African crime of fraud and the notion that cases of potential prejudice should rather be treated as attempted fraud,[104] the alleged vagueness of the crime has passed constitutional muster. The court held as follows:

> "The present definition of fraud is wide, but that does not make it difficult, much less impossible, to ascertain the type of conduct which falls within it….I find nothing objectionable in the approach which punishes fraud not because of the actual harm it causes, but because of the possibility of harm or prejudice inherent in the misrepresentation….The type of prejudice relied upon by the State, and hitherto accepted by the Courts, is not in my view so repugnant to, or so far removed from, what I conceive to be the moral values of the man in the street, that a reappraisal of the common-law definition of fraud is either warranted or necessary."[105]

### 3.5 *Conclusion*

The use of a counterfeit card, either at an ATM to withdraw money from the account of the legitimate owner of the originally issued payment card, or to pay for merchandise, constitutes fraud with the misrepresentation being made to the bank and the merchant respectively. When a computer system is hacked and data required for the perpetration of card-not-present fraud or for the manufacturing of counterfeit payment cards, are being accessed and copied, the hacker will commit fraud.[106] A hacker breaking the username and password protection makes a misrepresentation to the system administrator or anybody in control of the computer that he is an authorised user of the computer. The actions of the hacker will at least cause potential prejudice or harm and one should be able to prove his intention to defraud.

## 4 *Statutory offences*

Technology has become the "weapon of choice" among white-collar criminals. It is also embraced by regular "street criminals".[107] Internationally, legal systems are being challenged with the ever-increasing surge of technology and the fast-moving world of information. Like most other countries South Africa has introduced various pieces of legislation to address the legal problems brought by the use of technology.[108] At the heart of the legislation related to information and communication technology, is often the protection of data. The question is

[103] In such a case the card is blocked by the bank and the client will not only be without the facility until the payment card has been replaced, but will also be subjected to the bank processes relating to the application of replacement cards which could be time-consuming and cumbersome.
[104] See De Wet and Swanepoel *Die Suid-Afrikaanse Strafreg* 1985 391-2 and Burchell (n 13) 843.
[105] *Friedman (1)* 1996 1 SACR 181 (W) 194B and H and 195D – E.
[106] For a detailed argument on why hacking into computers constitutes fraud, see Ebersöhn "A common law perspective on computer-related crimes (2)" 2004 *THRHR* 193 196 – 203.
[107] Naude "Rekenaarmisdaad: 'n skewe beeld?" 1983 *SACC* 165.
[108] See Barker "Trespassers will be prosecuted: computer crime in the 1990s" 1993 *Computer Law Journal* 61 for a discussions of different ways in which computers are used to commit crime and the US legal response to that.

whether the legislation recently introduced in South Africa sufficiently protects the data contained on payment cards.

### 4.1 Statutory offences specifically aimed at cyber-related crimes

The criminalisation of unauthorised access to and the modification of data was the focus of a discussion paper "Computer related crime: preliminary proposals for reform in respect of unauthorised access to computers, unauthorised modification of computer data and software applications and related procedural aspects" published on 2 July 2001 by the South African Law Commission, which has since had its name changed to the South African Law Reform Commission.[109] One of the recommendations made in the discussion paper was that legislation be considered to introduce new cyber offences.[110] The paper highlighted three vulnerabilities of information technology not being addressed by the South African common law at that stage: unauthorised access to any database, unauthorised modification of data and software applications. The unlawful copying and subsequent use of data was seemingly not specifically considered.[111]

The Department of Communications subsequently released a green paper on electronic commerce, which ultimately resulted in the ECT Act, which has been in operation since 30 August 2002.[112] The Regulation of Interception of Communications and Provision of Communication-Related Information Act (RICA)[113] was assented to on 30 December 2002, but only came into force on 30 November 2005.[114]

The nature of the technology and equipment used and the nature of the use thereof determine the applicability of the available legislation aimed at addressing cyber-crime. Since credit and debit cards with magnetic strips, as well as chip-and-PIN payment cards contain data that involves some form of computer and information technology, Maat, in our view, correctly submits that the ECT Act will be applicable to all such cards.[115] RICA will similarly apply if the devices used and the unlawful activities alleged meet the requirements set out in the Act.

#### 4.1.1 Electronic Communications and Transactions Act 25 of 2002 (ECT Act)

One of the stated objects of the ECT Act is to "develop a safe, secure and effective environment for the consumer, business, and Government to conduct and use

[109] Discussion Paper 99 Project 108.

[110] The Commission considered the common-law offences of malicious injury to property, housebreaking and trespassing under the Trespass Act 6 of 1959 and concluded that the South African criminal law could not deal with unauthorised modification of computer data or unauthorised access to computers.

[111] This oversight is probably due to it being seen as an extension of unauthorised access to a database.

[112] *GG* 23809 (30 August 2002). For a general discussion of the impact of the ECT Act on electronic commerce, see Coetzee "The Electronic Communications and Transactions Act 25 of 2002: facilitating electronic commerce" 2004 *Stell LR* 501. Before the introduction of the ECT Act a number of authors argued that it was time for legislative action designed to tighten up the law in connection with the abuse of computers and/or technology. Examples include Van der Merwe (n 24) (1983) 124 and Horwitz "Computer abuse – the legal implications" 1986 *De Rebus* 503.

[113] 70 of 2002. For a discussion of the impact of RICA on telecommunication service providers see Van Rensburg "Intercepting communications and providing communication related information" 2003 *JBL* 90.

[114] Van der Merwe *et al Information and Communications Technology Law* (2008) 390.

[115] Maat (n 29) 15.

electronic transactions".[116] The ECT Act is aimed at the protection of "data" or "data messages".[117] "Data" is defined in section 1 as the "electronic representation of information in any form", whilst "data message" is defined in the same section as "data generated, sent, received or stored by electronic means and includes ... (b) a stored record".

Section 86(1) of the ECT Act deals with the unauthorised access and interception of data, whilst section 86(2) deals with the unauthorised modification or destruction of data. Hacking of a system or database with the intention to obtain protected data to facilitate the crimes of counterfeit card fraud or card-not-present fraud, has thus been criminalised by section 86(1) of the ECT Act. The unauthorised access to the data on the magnetic strip, or microchip of a payment card facilitated by either a handheld skimmer or a ATM-mounted high-tech skimming device will also constitute a contravention of section 86(1).[118]

For purposes of counterfeit card fraud, section 86(2) is not relevant due to the data on the magnetic strip of a payment card not being modified during the copying of the data with the use of a skimming device, regardless of whether it is a handheld or a high-tech skimmer.

Section 86(3) prohibits a number of unlawful activities and reads as follows:

> "A person who unlawfully produces, sells, offers to sell, procures for use, designs, adepts (*sic*) for use, distributes or possesses any device, including a computer program or a component, which is designed primarily to overcome security measures for the protection of data, or performs any of those acts with regard to a password, access code or any other similar kind of data with the intent to unlawfully utilise such item to contravene this section, is guilty of an offence."

The ECT Act does not provide a definition of "device", but states that it includes a "computer program" or "a component". The ordinary dictionary meaning of "device" is "a thing made or adapted for a particular purpose, especially a piece of mechanical or electronic equipment".[119] In terms of the ECT Act the device must, however, have been designed primarily to overcome security measures for the protection of data. According to Ebersöhn security measures can serve one or more of three purposes:

> "…the measures may protect data from
> - unauthorized access;
> - unauthorized copying, including distribution or printing; or
> - unauthorized modification, deletion, or corruption."[120]

When considering card skimming, the security measures relevant to a payment card would be the track data on the magnetic strip or microchip, coupled with the PIN, when the card is used to transact at an ATM. This is to authorise electronic access to the bank account of the legitimate card holder.[121] A high-tech skimmer is a purpose-built device specifically designed to fit on the card slot of an ATM

[116] s 2(1)(j). For a discussion of the crimes provided for in the ECT Act, see Watney "Die strafregtelike en prosedurele middele ter bekamping van kubermisdaad (deel 2)" 2003 *TSAR* 241 – 245. For a discussion of some of the other objectives of the ECT Act see Coetzee "Incoterms, electronic data interchange, and the Electronic Communications and Transactions Act" 2003 *SA Merc LJ* 1.
[117] Cassim (n 4) 57.
[118] For a discussion of ATM-mounted skimming devices, see par 5.4.2 below.
[119] Soanes and Stevenson *Concise Oxford English Dictionary* (2009) 392.
[120] Ebersöhn "Catching hackers" 2004 *JBL* 14 17.
[121] For a discussion of track data see par 5 below.

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and for the exclusive purpose of copying and storing the data contained on the magnetic strip or microchip of payment cards used to access clients' accounts. It thus meets the requirements set out in section 86(3) of the ECT Act. A mould with a built-in pinhole camera, which has been designed and manufactured to be fitted as part of the fascia of an ATM in order to record the PIN when entered by the client of the bank transacting using the ATM, will similarly meet the requirements set out in section 86(3).

Handheld skimmers were, however, initially primarily designed for use by employers such as factory owners to monitor time and attendance. Although such devices are currently also frequently being used by fraudsters to overcome "security measures for the protection of data", it may be problematic for the prosecution to prove that the device was "designed primarily to overcome security measures for the protection of data".[122] It would have been preferable had the legislature rather used the words "which is used or can be used to overcome security measures for the protection of data".[123] It is recommended that the wording of section 86(3) be amended to address the possible or even intended use of the device rather than the purpose of the design.

Counterfeit payment cards are manufactured with the sole purpose of enabling unauthorised access to and utilisation of the money or credit of the legitimate card holder. To achieve this goal it is essential to overcome the security measures created to prevent such unlawful access. An argument that counterfeit payment cards are devices as contemplated in section 86(3) of the ECT Act should thus succeed.

None of the other "tools of the trade" however meets the requirements set out in section 86(3) of the ECT Act.[124]

In terms of section 86(4) a person who utilises any device or computer program mentioned in section 86(3) to unlawfully overcome security measures designed to protect such data or access thereto, is also guilty of an offence. The mere possession of the devices described in section 86(3) thus constitutes an offence, whilst the utilisation thereof constitutes a further offence.

Section 87(2) of the ECT Act criminalises computer-related fraud and reads as follows: "A person who performs any of the acts described in section 86 for the purpose of obtaining any unlawful advantage by causing fake data to be produced with the intent that it be considered or acted upon as if it were authentic, is guilty of an offence." Contravention of section 87(2) of the ECT Act seems to be an appropriate charge when phishing is being prosecuted. However, due to the low maximum penalty provided for in the ECT Act, it would be prudent in such circumstances to rather prosecute for the common law offence of fraud and to add a contravention of section 87(2) as an alternative charge.

Section 88 criminalises any attempt to commit an offence referred to in section 86, as well as aiding and abetting of a person to commit such an offence.

Jurisdictional matters are regulated by section 90 of the ECT Act and a South African court will, *inter alia,* be vested with jurisdiction where only part of the

[122] Although perpetrators are often convicted of the contravention of s 86(3) and/or s 86(4) in respect of the possession and/or utilisation of handheld skimming devices, these convictions mostly followed guilty pleas and to date it has never been challenged whether a handheld skimmer meets the definition.

[123] This is similar to the wording used in the definition of an interception devise in s 1 of RICA.

[124] For a description of "tools of the trade" see par 3.1 below.

offence was committed in the Republic or if the result of the offence had an effect in the Republic.[125]

The maximum period of imprisonment for the crimes prohibited by sections 86(1) and 86(3) of the ECT Act is one year, whilst a conviction of a contravention of section 86(4) could result in a fine or imprisonment for a period not exceeding five years.[126] Van der Merwe correctly points out that these penalty provisions, when compared with those of similar legislation, such as RICA, seem "woefully inadequate".[127] Ironically, anybody who assists the fraudsters to launder the proceeds of a crime such as counterfeit card fraud is liable to a fine not exceeding R100 million or to imprisonment for a period not exceeding 30 years.[128]

Before enactment of the ECT Act there were no provisions in either the South African common law or statutory law that prohibited the possession of, trafficking in, or utilisation of devices used to overcome security measures for the protection of data.

According to Cassim the "ineffectiveness of the South African common law to combat cybercrime" led to the promulgation of the ECT Act.[129] Whether it sufficiently addresses the problem is debatable.[130] As mentioned above it is, for instance, questionable whether skimming with a handheld skimming device or even possession of such a device will constitute a contravention of the ECT Act, since a handheld skimmer may not be "designed primarily to overcome security measures for the protection of data".[131] Unlawful possession and utilisation of "tools of the trade" other than high-tech skimmers are also still not criminalised.[132] Until now the legislature has not used the opportunity to criminalise the unlawful copying and subsequent use and/or distribution of data.

#### 4.1.2 Regulation of Interception of Communications and Provision of Communication-Related Information Act 70 of 2002 (RICA)

RICA regulates certain communications, but also enacts certain criminal offences.[133] The manufacturing, assembling, possessing, selling, purchasing or advertising of any "listed equipment" constitutes a criminal offence.[134] The unlawful interception or attempted interception of communication during the course of its occurrence or transmission has also been criminalised.[135]

Unlike the ECT Act, the penalty provisions in RICA have a sufficient deterring impact. Section 51 provides for imprisonment of up to 10 years and fines not exceeding R2 000 000.

[125] s 90(b).
[126] s 89. Since the sanction for a contravention of s 86(4) is heavier than that provided for a contravention of s 86(1), it is recommended that perpetrators using high-tech skimmers to access track data, rather be charged with a contravention of s 86(4).
[127] Van der Merwe *et al* (n 114) 78.
[128] s 8 of the Prevention of Organised Crime Act 121 of 1998.
[129] Cassim "Addressing the growing spectre of cyber crime in Africa: evaluating measures adopted by South Africa and other regional role players" 2011 *CILSA* 123 127.
[130] Ebersöhn identified at least one omission, namely not criminalising the removal of a digital watermark (n 42) 17.
[131] Accessing the data with a handheld skimmer will, however, constitute a contravention of s 86(1).
[132] See par 5.4.4 for a description of "tools of the trade".
[133] ch 9 of Act 70 of 2002.
[134] s 45 read with s 44 and 51.
[135] s 49 read with section 51.

In its endeavour to ensure that the provisions of RICA will be as far reaching as possible, the legislature burdened us with a number of very broad and often rather confusing definitions, examples of which are the definitions of "listed equipment", "interception device" and "monitoring device". "Listed equipment" is defined as "any electronic, electro-magnetic, acoustic, mechanical or other instrument, device or equipment, the design of which renders it primarily useful for purposes of the interception of communication"[136] declared as such by notice in the Government Gazette.

This definition has been expanded upon by a schedule of listed equipment,[137] being "any instrument, device or equipment which is capable of being used to access, record, monitor or retrieve communications from a computer, without the permission of the author of the communication",[138] for example: keystroke recorders; "any instrument, device or equipment which is capable of being used to record, monitor or listen to a communication",[139] such as miniature sound recording devices; "any instrument, device or equipment which is capable of being used to visually record, monitor or observe a communication",[140] including a miniature camera; and "any instrument, device or equipment which is capable of being used to determine or monitor the geographical location of a person, vehicle or object".[141] The conditions under which the abovementioned instruments, devices and equipment are considered to be "listed equipment" are specified.[142] The breadth of the definition of "listed equipment" is indicative of the legislature's endeavour to criminalise the manufacturing, assembling, selling, purchasing, advertising and possessing of any equipment which could be used to unlawfully intercept communications.

The legislature nevertheless deemed it necessary also to define "interception device".[143] "Monitoring device" was also widely defined as "any electronic, mechanical or other instrument, device, equipment or apparatus which is used, whether by itself or in combination with any other instrument, device, equipment or apparatus, to listen to or record any communication".[144] High-tech skimming devices and pinhole cameras seem to fit the definitions of listed equipment,

[136] s 44.

[137] The Minister of Justice and Constitutional Development introduced in reg 1263 as promulgated under *GG* 28371 (29 Dec 2005) a schedule of "listed equipment" as provided for in s 44 of RICA.

[138] *GG* 28371 (n 131) column 1(1).

[139] *GG* 28371 (n 131) column 1(2).

[140] *GG* 28371 (n 131) column 1(3).

[141] *GG* 28371 (n 131) column 1(4).

[142] They are specified as follows "[t]o manufacture, assemble, possess, sell, purchase or advertise any of these instruments, devices or equipment, with the intention to use it, whether by itself or in combination with any other instrument, device, equipment or apparatus for the purposes of unlawful interception of communications in contravention of section 49… ." See *GG* 28371 (n 131) column 2(1).

[143] An "interception device" means "any electronic, mechanical or other instrument, device, equipment or apparatus which is used, whether by itself or in combination with any other instrument, device, equipment or apparatus, to intercept any communication, … and a reference to an 'interception device' includes, where applicable, a reference to a 'monitoring device'"

[144] "Monitor" "includes to listen to or record communications by means of a monitoring device".

monitoring devices and interception[145] devices for the purpose of prosecutions under RICA and the possession, manufacturing, assembling, selling, purchasing and advertising thereof will constitute a contravention of section 45. It is clear that the legislature also meant for "interception" to be interpreted widely.

In terms of section 1 of RICA "communication" includes both direct and indirect communication.[146] "Direct communication" includes both oral communication and audible utterances.[147]

In terms of section 2 of RICA the interception of communication "in the course of its occurrence or transmission" is prohibited. This requirement may prove to be problematic when prosecuting for the use of an ATM-mounted skimming device to acquire the track data on the magnetic strip or microchip of a card while it is used at an ATM to transact or "communicate" with the bank. The same challenge will not be encountered in respect of a pinhole camera being used to intercept the communication of the PIN of the client when entered on the keypad of the ATM. In both instances the data communicated to authorise access to the client's account is made available to "a person other than the sender, recipient or intended recipient of that information".

A high-tech skimming device is usually placed on the outside of the ATM card slot and the track data on the payment card is thus technically read by the skimmer before it is read by the ATM card reader which reads the track data to identify the card and account holder before instructions on the keypad to effect transactions are allowed to the bank.[148] For sections 2 and 49 of RICA to apply to the unlawful acquisition of the track data on the magnetic strip or microchip of a payment card through the use of an ATM-mounted high-tech skimming device, one will have to argue that the "communication" already commences when the card is put into the card slot and not only once the ATM card reader commences with the reading of the data in question. It is submitted that this argument should succeed, especially if it is taken into account that the payment card cannot reach the ATM card reader without first going through the skimming device coupled with the legitimate card holder's intention to communicate with his or her bank when he or she starts to put the card in the card slot of the ATM.

Since handheld skimmers are not used to intercept communication, but rather to copy and record the data on the magnetic strip of the card during a separate action,[149] it will not meet the requirements of any of the equipment or activities defined in RICA.

[145] "Intercept" is defined as "the aural or other acquisition of the contents of any communication through the use of any means, including an interception device, so as to make some or all of the contents of a communication available to a person other than the sender, recipient or intended recipient of that communication, and includes the- (a) monitoring of any such communication by means of a monitoring device; (b) viewing, examination or inspection of the contents of any indirect communication; and diversion of any indirect communication from its intended destination to any other destination."

[146] "Indirect communication" means the "transfer of information, including a message or any part of a message, whether- (a) in the form of – (i) speech, music or other sounds; (ii) data; (iii) text; (iv) visual images, whether animated or not; (v) signals; or (vi) radio frequency spectrum; or (vii) in any form or in any combination of forms, that is transmitted in whole or in part by means of a postal service or a telecommunication system.

[147] Direct communication thus includes both oral communication between any number of people in one another's presence and indirect communication overheard by another person, such as a telephone conversation.

[148] For a discussion of ATM-mounted skimming devices see par 5.4.2 below.

[149] For a discussion of handheld skimming devices see par 5.4.2 below.

Although there have been a number of convictions for the contravention of section 2 read with section 49 and/or of section 45 read with section 44 and further read with sections 1 and 51 of RICA when accused are charged for the possession and use of card readers or skimming devices and cameras to intercept the PIN of the legitimate payment card holder,[150] these convictions followed plea and sentence agreements with the accused.[151] The appropriateness of the charges has therefore not been challenged or tested yet. Should any of these charges be challenged, the definitions in the legislation may be an obstacle and it is recommended that they be reviewed and simplified to facilitate the prosecutions of the activities they criminalised.

None of the provisions of RICA has been tested in the constitutional court and Van der Merwe questions whether especially the presumptions accompanying the criminal provisions will withstand constitutional scrutiny.[152]

### 4.2 Other relevant statutory provisions

#### 4.2.1 Prevention of Organised Crime Act 121 of 1998 (POCA)

This legislation was, *inter alia,* enacted to introduce measures to combat organised crime, money laundering and criminal gang activities, and created the offence of racketeering. In the preamble of POCA a number of factors contributing to the decision to enact the legislation are listed. They include:

- the rapid growth of organised crime, money laundering and criminal gang activity nationally and internationally;
- the identification of organised crime as an international security threat;
- the infringement of organised crime, money laundering and criminal gang activity on the rights of the people of South Africa as enshrined in the Bill of Rights;
- the potential to inflict social damage and the danger presented to public order, safety and economic stability by organised crime, money laundering and criminal gang activity;
- the difficulty to prove direct involvement of organised crime leaders in particular cases due to them not performing the actual criminal activities; and
- the fact that the South African common law and statutory law fail to deal effectively with organised crime, money laundering and criminal gang activities and also fail to keep pace with international measures aimed to deal effectively therewith.

"Criminal gang" is defined as to include:

> "any formal or informal ongoing organisation, association, or group of three or more persons, which has as one of its activities the commission of one or more criminal offences, which has an identifiable name or identifying sign or symbol, and whose members individually or collectively engage in or have engaged in a pattern or criminal gang activity".[153]

The inclusion of the requirement of an "identifiable name, sign or symbol" excludes the known organised criminal groupings currently involved in counterfeit card fraud. The offences criminal gang activities provided for also relate mainly to violent crime.[154]

[150] Examples include *Foo Hui Ooi* case no CCC1/32/11 East London Commercial Crime Court (unreported) and *Xotongo* case no 29/08 Matatiele Magistrates Court (unreported).
[151] Provided for in s 105A of the Criminal Procedure Act.
[152] Van der Merwe *et al* (n 114) 30.
[153] s 1.
[154] s 9.

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An "enterprise" is defined to include "any individual…, association, or other juristic person…, and any…group of individuals associated in fact…".[155] Any crime syndicate, whether formally or informally organised, would thus constitute an enterprise as envisaged in POCA.

Section 2(1) of POCA creates various offences related to racketeering activities. The one most often appropriate to counterfeit card fraud activities reads as follows: "whilst managing or employed by or associated with any enterprise, conducts or participates in the conduct, directly or indirectly, of such enterprise's affairs through a pattern of racketeering activity".[156] A "pattern of racketeering activity" has been defined as:

> "the planned, ongoing, continuous or repeated participation or involvement in any offence referred to in Schedule 1 and includes at least two offences referred to in Schedule 1, of which one of the offences occurred after the commencement of this Act and the last offence occurred within 10 years (excluding any period of imprisonment) after the commission of such prior offence referred to in Schedule 1."[157]

Schedule 1 offences include fraud, theft, forgery, uttering and any conspiracy, incitement or attempt to commit any offence referred to in Schedule 1.

A typical counterfeit card fraud syndicate would:

- have members responsible to obtain the "tools of the trade";
- recruit waiters, cashiers and others to assist with the skimming of payment cards using handheld skimming devices and the noting of PIN numbers;
- recruit persons to install high-tech skimming devices and cameras at ATMs and subsequently remove the devices;
- use skilled people to download data retrieved with skimming devices;
- possibly use hackers to obtain confidential card data or bribe people to disclose such data;
- use skilled people to manufacture counterfeit payment cards; and
- use people to present counterfeit cards for payment and/or people to withdraw cash at ATMs using counterfeit cards.

In the typical syndicate scenario various people perform various activities at different times and places and they need not know one another. It is also not a requirement for any member of the syndicate or enterprise to participate in all the related activities or to even know the detail thereof.

The legislature makes provision for the admission of evidence in a prosecution on racketeering charges that would otherwise have been inadmissible, such as hearsay evidence and evidence of similar facts and relating to previous convictions.[158]

The penalties provided for in POCA are significantly harsher than the penalties contained in any of the other statutory offences relevant to counterfeit card fraud. A person convicted of racketeering offences faces a fine not exceeding R1 000 million or imprisonment for a period up to imprisonment for life.[159] POCA also provides for various offences related to money laundering or the proceeds of unlawful activities and any of the runners or mules involved in making payments

[155] s 1.
[156] s 2(1)(e).
[157] s 1.
[158] s 2(2).
[159] s 3(1).

by using counterfeit payment cards or in withdrawing cash from ATMs with such cards, as well as "friendly merchants", could be prosecuted for these.[160] A person so convicted is liable to a fine up to R100 million or imprisonment for a period not exceeding 30 years.[161]

The criminal and civil recovery and/or forfeiture actions provided for in POCA should also be considered to disrupt the activities of syndicates involved in counterfeit card fraud.

#### 4.2.2 Identification Act 68 of 1997

Section 18(1) of the Identification Act creates various offences related to the possession of forged identity documents, the forgery or alteration of identity documents and the presentation of incorrect particulars or somebody else's identity document as his or her own. These offences are punishable with a fine or imprisonment for a period not exceeding five years.[162] Prosecution for these offences should be considered when a fraudster using a counterfeit payment card submits forged identity documents when asked to submit proof of her/his identity or when false identity documents are seized during the arrest of any of the members of a syndicate involved in counterfeit card fraud.

## 5 *Bank payment card fraud*

### 5.1 Introduction

The revolution in banking in general and payment methods specifically has predominantly been caused by changes in information technology, communication technology, and globalisation.[163] Payment can nowadays be effected in various ways of which payment by means of a credit or debit card is one. Despite a payment card not being a form of money and not qualifying as legal tender,[164] their use as instruments or methods of payment is not only generally acceptable in the modern economy, but has surpassed the use of cash and negotiable instruments such as cheques by far.[165]

The increased number of customers and transactions involving the withdrawal of cash forced banks to introduce cash dispensers enabling depositors and borrowers to

[160] s 4 – 6.
[161] s 8.
[162] s 18(2).
[163] Schulze "Countermanding an electronic funds transfer: the supreme court of appeal takes a second bite at the cherry" 2004 *SA Merc LJ* 667. See also Oelofse "Enkele regsaspekte van ontwikkelings in die bankwese" 1985 *MBL* 6.
[164] Gering *Handbook on the Law of Negotiable Instruments* (2007) 86 ff; Stassen "Betaling deur middel van 'n driepartykredietkaart" 1978 *De Jure* 134 135; Stassen and Meiring "Ongemagtigde kredietkaartgebruik: wie dra die skade?" 1979 *MBL* 28; Schulze "E money and electronic fund transfers. a shortlist of some of the unresolved issues." 2004 *SA Merc LJ* 50; and s 17 of the South African Reserve Bank Act. See also Stassen "Some legal aspects of credit cards – III Paying by credit card" 1978 *BML* 12 13, where the author argues that a merchant who advertises that he will accept certain credit cards, makes an offer and will be obliged to accept payment through the credit card system once a contract has been concluded with the consumer.
[165] Malan "The liberation of the cheque" 1978 *TSAR* 107. See Malan *et al Malan on Bills of Exchange, Cheques and Promissory Notes* (2009) 5 ff for a discussion of negotiable instruments. For a discussion of the history of payment cards and the development of the security markings thereof, see Schulze "Smart cards and e-money: new developments bring new problems" 2004 *SA Merc LJ* 703 – 708.

withdraw cash 24 hours a day.[166] Cash dispensers were subsequently replaced by ATMs allowing for a bigger range of banking business to be conducted 24 hours a day, seven days a week.[167] An ATM can be described as "a computerized telecommunications device that provides the clients of a financial institution with access to financial transactions in a public space without the need for a cashier, human clerk or bank teller".[168] Typically an ATM connects directly to its host via either ADSL or dial-up modem over a telephone line or directly via a leased line. ATM devices in remote areas will usually rely on a dial-up modem connected to a telephone line. An ATM-activated payment card also serves as a means to access cash.

To accommodate the use of technology in banking, an electronic funds transfer system (EFT) was introduced. It is a generic term and includes various devices employed to transfer funds without the use of paper, including ATMs and the transfer of funds at point of sale.[169] For both these types of transactions bank payment cards are used to identify the account holder and to grant access to the client's account.

Bank payment cards predominantly consist of debit,[170] credit and charge cards.[171] Fraud types experienced in respect of these payment instruments comprise counterfeit card fraud, card-not-present card fraud, fraud committed using stolen or lost cards, and fraudulent use of cards obtained through application fraud. According to Sabric, the banking industry's gross fraud losses due to South African-issued credit card fraud decreased by 28.6%, from R353.3 million in 2014 to R252.2 million in 2015, while the gross fraud losses due to fraud perpetrated with South African-issued debit cards increased by 8.3%, from R237.4 million in 2014 to R257.1 million in 2015.[172]

Currently the biggest contributors to payment card fraud are counterfeit card fraud and card-not-present fraud.

### 5.2 Card-not-present fraud

Card payment transactions that are not made face-to-face are known as card-not-present transactions. Fraudulent purchases are often made telephonically, per fax or on the internet.[173] In such cases account information, including pseudo-account information, is used without the involvement of a physical card. Unlike the case

[166] Visser "The evolution of electronic payment systems" 1989 *SA Merc LJ* 189 198.
[167] Visser (n 166) 198.
[168] See Wikipedia encyclopaedia "automated teller machine" http://en.wikipedia.org/wiki/Automated_teller_machine (30-4-2012).
[169] Visser "Banking in the computer age: the allocation of some of the risks arising from the introduction of automated teller machines" 1985 *SALJ* 646 647.
[170] A garage-card is a debit card. See Dijkman "Garage-card fraud, a solution" 1986 *BML* 35.
[171] Disputed transactions in respect of all forms of payment cards are normally resolved through chargeback mechanisms. For a discussion of the chargebacks and the chargeback process see Buys Ed *Cyberlaw@SA II* (2004).
[172] South African Banking Risk Information Centre (SABRIC) Card Fraud South Africa 2015. https://www.sabric.co.za/media/1146/final-card-booklet.pdf. (30-9-2016).
[173] For an analysis of the legal nature of a card payment over the Internet, see Lawack "Electronic innovations in the payment card industry" 1998 *SA Merc LJ* 233. What is of concern is that consumers in South Africa do not enjoy the same legal protection as consumers in the European Union in the case of fraudulent card payment in distance-selling contracts such as when a fraudulent purchase is made over the internet. In this regard see Lawack-Davids and Marx "Consumer protection measures for erroneous or unauthorized internet payments: some lessons from the European Union?" 2010 *Obiter* 446 457.

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with face-to-face transactions, online transactions are not protected by some of the security features such as signatures and chip technology. During online transactions no verification is performed to establish whether the purchaser is authorised to use the account.[174] To commit card-not-present fraud, the fraudster requires the personal details of the victim, in particular the name in which the legitimate card has been issued, the card number, the expiry date of the card and the CVV[175] or CVC[176] number of the card.[177] The CVV and CVC numbers are the three- or four-digit card security numbers on cards, which are designed to validate that a genuine card is being used during the transaction.[178]

Any stolen card or lost card that fell in the wrong hands could be used to commit card-not-present fraud.[179] Only once the legitimate cardholder reports the loss or theft to her/his bank and the card is blocked, are further transactions prevented.

In order to make this type of fraud profitable, it has to be perpetrated on a large scale, requiring the card data of a large number of people. Although the data could be obtained by bribing an employee with access to such data, the easiest way to obtain the required volume is through hacking of card data or phishing. In respect of phishing, the financial services are the most targeted industry sector. One such malicious computer program available to hackers to obtain credit card information by recording keystrokes of card owners and transmitting them to a third party via the Internet, is a Trojan.[180]

The card data thus obtained could be used to manufacture counterfeit payment cards, but due to the absence of track data such cards would have limited use and can only successfully be used for purchases under the floor limit. The data as such is, however, a commodity and is often either sold for use overseas, where the floor limits are usually higher, or traded for another instrument acquired by another syndicate, for example identity books, for subsequent use to facilitate or perpetrate various criminal activities.

Kalyani Pillay[181] said card not present fraud (CNP) losses increased by 12.6% (R168.1 million in 2014 to R189.2 million) in 2015, and that it "remained the biggest contributor of fraudulent expenditure on SA-issued credit cards (75%) during 2015".[182] She attributed the rise of CNP fraud to the increase in online transactions among the South African populace, adding that criminals were stealing users' identities as well as card details to steal money. According to Pillay, the criminals are mostly making use of social engineering as well as phishing to extract important banking details from the unsuspecting users.

[174] Clough *Principles of Cybercrime* (2010) 186.

[175] Visa's card verification value.

[176] MasterCard's card validation code.

[177] All the required data is available on a bank payment card.

[178] Wells *Encyclopedia of Fraud* (2007) 271. Since the CVV or CVC is not available when counterfeit payment cards are manufactured, such cards cannot successfully be used for card-not-present fraud.

[179] Although lost and stolen cards could also be used as counterfeit cards once re-encoded with details of another card, they are more often used to commit card-not-present fraud.

[180] Henning and Ebersöhn "Insider trading, money laundering and computer crime" 2001 *Transactions of the Centre of Business Law: Combatting Economic Crime* 105 112 – 113. As explained in Verma *Cyber Crimes & Law* (2009) 58, a Trojan is "an unauthorised program which functions from inside what seems to be an authorized program, thereby concealing what it is actually doing".

[181] CEO of SABRIC..

[182] Moyo "Online dents decline in card fraud" ITWeb 18 Nov 2015 www.itweb.co.za/index.php?option=com_content&view=article&id=147891 (30-9-2016)

## 5.3 Counterfeit card fraud

The fastest growing type of bank card fraud in South Africa is counterfeit card fraud. Counterfeit card fraud can be described as fraud arising from a card that has been illegally manufactured with information stolen from the magnetic strip of a genuinely issued card.[183] The magnetic strip affixed to the back of a payment card contains essential cardholder and account information, including the account number and expiry date.[184] The information required to manufacture counterfeit cards is usually obtained through card skimming.[185]

Since the early 1970s the standard security backbone of all payment cards has been the magnetic strip with which they are issued that comprises two or three tracks of confidential data in machine readable format.[186] However, the increased access to and use of technology by organised criminal groupings nowadays cause this security feature to pose a security risk. Access to the data on the magnetic strip enables criminals to manufacture counterfeit payment cards that are used to steal the legitimate card holder's available credit. Magnetic strip cards are vulnerable to compromise since the information is magnetically encoded and stored on the exterior of the card, thereby allowing the data to be read, copied, deleted, forged, altered or rewritten at will by anyone with access to the appropriate read/write device.[187]

Due to the vulnerability of the magnetic strips on payment cards, South African banks decided to replace these cards with cards containing an embedded microprocessor chip.[188] The data is burnt into the microprocessor chip on the card and can be read by a scanning device or smart card reader when the specific security access codes (usually a personal identification number) associated with the data contained in the card is entered.[189] The microprocessor chip thus stores the data in a more secure manner and together with a personal identification number, a secret numeric password that is shared between the user and the system used to authenticate the user to the system,[190] offers better security to clients. Although all South African banks have rolled out "chip-and-PIN" cards to replace credit cards, most debit cards are still issued with magnetic strips. "Chip-and-PIN" furthermore does not completely prevent counterfeit card fraud.[191]

Counterfeit card fraud has increasingly become a faceless crime. Identifying and arresting the perpetrators have become more challenging due to the movement

[183] Anonymous "Counterfeit cards drive up card fraud losses" *The Professional Accountant* (May/June 2009) 24 25.
[184] This data is collectively known as the "track data".
[185] Card skimming is the copying of encoded information from the magnetic strip of a legitimate card using a card reader in order to use the data to encode blank cards (also known as "white plastic"), lost or stolen cards for fraudulent use.
[186] Schulze (n 165) 705.
[187] Watney (n 53) 517.
[188] The microcomputer chip embedded on a chip-and-PIN card does not only have a significantly bigger memory enabling it to store vast amounts of confidential data, but it also has robust security features involving the utilisation of a secret key embedded on the chip to recognise a randomly coded challenge sent to it by the payment terminal. In this regard see Schulze (n 164) 54 – 55.
[189] Henning and Ebersöhn (n 177) 137. For a discussion of the features of a "chip" card see Faul "Die 'smart' kaart – hoe werk dit?" 1989 *SA Merc LJ* 381.
[190] As explained by Schulze in "Duty of a bank to act with necessary skill and care when issuing an automated teller machine card" 2007 *De Jure* 370 375, the PIN serves as "signature" and authentication when a bank payment card is used to withdraw cash at an ATM and the money will only be paid out by the ATM if the correct PIN is keyed in.
[191] For a discussion of the continued vulnerability of payment cards in respect of counterfeit card fraud, see Van der Bijl "The cloning of credit cards: the dolly of the electronic era" 2007 *StellLR* 331.

towards greater anonymity in the choice of *modus operandi*. Through the increased use of sophisticated high-tech skimming devices that are attached to ATMs, more perpetrators do not interact physically with any person, thus reducing the threat of identification and arrest of both the person responsible for the skimming of a card and of the person using a counterfeit card. One can safely concur that "computer crime by means of the ATM is alive and well and living dangerously in South Africa".[192] To combat this type of offence effectively, the identification, arrest and prosecution of all role players in the business value chain of counterfeit card fraud are thus of increased importance.

When fraudsters present counterfeit payment cards in a commercial transaction, the criminal activity is seemingly covered by the common-law offences of theft and fraud. The crimes relating to possession and use of devices such as high-tech skimmers, which were primarily designed to overcome security measures for the protection of data, are being prosecuted as contraventions of the ECT Act. There are no known prosecutions to date for other criminal activities related to counterfeit card fraud, such as the use of a card encoder or embosser to produce the counterfeit cards or mere possession of counterfeit cards.

### 5.4 How is this happening?

#### 5.4.1 Introduction

Counterfeit bank payment cards can either be newly manufactured or re-encoded cards. Newly manufactured cards are cards that are manufactured from scratch starting with so-called "white plastic",[193] while a re-encoded card is usually a lost or stolen card of which the magnetic strip has been re-encoded with unlawfully obtained track data. In the majority of cases "white plastic" is used.

The life cycle of counterfeit card fraud where the aim is to produce newly manufactured cards for use, consists of various stages, including obtaining all relevant data, downloading the data, manufacturing the counterfeit cards, distributing, and using the cards.[194] In the typical counterfeit card fraud syndicate different people will be responsible for executing the different activities and some of the perpetrators may be working for more than one syndicate or organised crime grouping. As technology becomes more sophisticated and user-friendly, so does its role increase in each of the different stages of the life cycle of the fraud. With reference to the growing concern regarding the role of cybercrime in organised crime, Walden made the following observation:

> "Concerns about the spotty teenager hacking into military systems motivated by mere curiosity have been largely transferred to concerns about the criminal organization, mafia-style, involved in every sector of profitable criminality, from counterfeiting to child pornography, malware to spam, and operating on a transnational basis."[195]

The criminal business value chain can be broadly divided into the following categories: obtaining the required equipment and information; manufacturing the counterfeit payment cards; and utilising these cards to obtain cash. Each of these is briefly examined below.

[192] Carstens and Trichardt (n 84) 129.
[193] This would be the case when purchased white plastic already has a magnetic strip at the back.
[194] In instances where the objective is to use the card without physically presenting it, so-called card-not-present fraud, obtaining and using the relevant card information are the only requirements.
[195] Walden *Computer Crimes and Digital Investigations* 2007 66.

### 5.4.2 Obtaining the required information

Criminals require both the track data encoded on the magnetic strip at the back of a payment card and the PIN belonging to the legitimate card holder to produce and use a counterfeit payment card.

Obtaining the personal information encoded on the magnetic strip of a legitimately issued bank payment card is essential to manufacture a counterfeit card, irrespective of whether the method requires re-encoding an existing bank payment card or manufacturing a counterfeit card using "white plastic". To achieve this perpetrators usually make use of skimming using an electronic or magnetic card reader better known as a skimming device.[196] Skimming can be described as the illegal copying of the encoded information from the magnetic strip of a card with the aid of a magnetic card reader. A skimming device is a physical device that can be used to read, copy and store electronic data from the magnetic strip of a bank payment card. By swiping the payment card of a client through the electronic card reader, the data contained on the magnetic strip is captured and stored. Such data can subsequently be downloaded from the skimming device with the aid of a computer terminal.

Electronic card readers are freely available and in the majority of instances bought on the Internet and/or imported. These devices are not currently manufactured in South Africa. Due to the wide legitimate use of these devices for access and security purposes, their importation is not regulated in South Africa. In South Africa both handheld and ATM-mounted skimming devices are encountered; the use of the latter, also known as high-tech skimming devices, is on the increase.

*Handheld magnetic card readers* or skimming devices can be used at any point of sale or payment where payment by bank cards is allowed, such as a restaurant or a tollgate. When a customer hands over the card for payment, the criminal also surreptitiously swipes the card through a handheld magnetic card reader, which copies and stores the track data copied on the magnetic strip. As explained by Fisher-French:

> "[r]estaurants especially are rife with waiters skimming information off cards. It just takes a couple of seconds to them to skim the card through a devise the size of a matchbox, and then all they have to do is watch you key in your PIN – hey presto, unfettered access to your account…".[197]

Handheld skimming devices are also frequently used at ATMs where unsuspecting victims are coerced into swiping their cards through the handheld card reader. Various permutations of this *modus operandi* have been experienced in South Africa. In most of the incidents reported the ATM card reader entry slot was damaged. The victim is then approached by the perpetrator who seemingly tries to help him. In the process the perpetrator takes the victim's card and escorts him to another ATM. By the time the victim receives his card back it has already been skimmed with a handheld skimming device. In other known cases a person purportedly working for the bank approached the client with a request to "re-activate" his card by swiping it through the skimming device. Handheld card readers have even temporarily been attached to an ATM together with a leaflet requesting the naive customer to swipe his card prior to or after making use of the ATM facility.

[196] Other methods of obtaining the sought information include corruption of an employee of the legitimate manufacturers of bank payment cards and hacking.

[197] "Chip-and-PIN cards: they're not as safe as you think…" *Personal Finance Newsletter* (January 2010) 8.

*ATM-mounted skimming devices* function differently. When online, the ATM is directly connected to the central computer of the financial institution and the transactions are processed immediately.[198] When offline, the transaction will be reflected on a tape at the machine and the consumer's account will only be credited once the information on the tape is registered in the bank's central computer.[199] When a typical ATM transaction is conducted, it involves the following steps:[200]

"(a) the customer inserts a plastic card into the terminal;
(b) he enters his PIN on a keyboard;
(c) the ATM instructs the customer by displaying messages on a screen;
(d) the customer presses the appropriate function key to indicate the transaction he wishes to perform;
(e) the customer enters the amount;
(f) the ATM displays the information the customer entered, and the customer presses an appropriate key to verify the transaction or to correct any mistakes; and
(g) the ATM completes the transaction."

The so-called high-tech skimmers used to retrieve the track data of cards legitimately used during ATM transactions vary in sophistication and appearance. Although some ATM-mounted skimming devices interfere with the ATM during its operation, the majority of the devices recovered from ATMs in South Africa fall in the category of devices that do not interfere with the operation of the ATM. When the skimming device is inserted in the place of the actual card reader, the functioning of the ATM is interfered with. The magnetic strip data is captured by the skimming device when the client enters his card, but since the actual card reader has been removed, the ATM does not read or respond to the card. The customer will assume the machine is broken and leave the ATM unaware of the fact that his card has been skimmed.

The devices more frequently used in South Africa look like the card reader entry point on the ATM and are fitted over the factory installed card reader slot. The magnetic card reader in the skimming device acquires and stores the track data on the magnetic strip when the card is inserted to conduct an ATM transaction. As in the case of a handheld skimming device, the data can be retrieved by disconnecting the device and downloading the information using a computer. In the case of more advanced technology being employed, the data can also be transmitted to the perpetrator within reasonable proximity using wireless technology.

Due to the fact that the high-tech skimmers are customised to fit precisely over the card slot of the targeted ATM, they only take seconds to install and remove. Since these devices are furthermore very small, fraudsters are not often caught "in the act" during the installation or removal. Having the appearance of a standard part of the terminal, high-tech skimmers are also very difficult to detect while attached to an ATM. Their retrieval is furthermore obstructed by the fact that the devices have usually already been removed when customers detect and report related fraudulent transactions on their bank accounts.

The risk of being identified and arrested using a high-tech skimming device is significantly lower than when a criminal uses a handheld skimmer. This explains

[198] Carstens and Trichardt (n 84) 125.
[199] The opportunity for fraud when an ATM is offline is significantly bigger than when online.
[200] Visser (n 169) 649.

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the increase in use of ATM-mounted skimming devices in comparison to the more traditionally used handheld skimming devices.

Further information that is essential for the successful use of a counterfeit card at an ATM is the PIN of the owner of the legitimately issued card. When a handheld skimming device is used to copy the encoded track data on the magnetic strip of a card, "shoulder surfing" is usually relied upon to obtain the PIN.[201] In the case of an ATM mounted skimming device, the PIN was at first obtained either through shoulder surfing or by using a pin-hole camera which was concealed within trunking and placed directly above the PIN pad to observe the PIN entry. More recently these miniature cameras are being installed in the same customised piece of equipment containing the false card reader which is installed on top of the legitimate card reader. In the latter case the information is then either transmitted using a wireless device, or stored for subsequent downloading and use. Another method of obtaining the PIN occasionally encountered is the placing of a transparent plastic overlay on the keypad which appears to serve as a cover to keep the keypad clean, but in reality contains microchips recording the keystrokes when the PIN is entered.[202] The skimmed card details and compromised PIN are subsequently matched for fraudulent use.[203]

Using the necessary software and USB cables, the data copied from the magnetic strips of cards is downloaded onto a computer. The software program required will depend on the skimming device used.[204]

### 5.4.3 Manufacturing counterfeit cards

The next phase in the life cycle and business value chain of counterfeit card fraud is the manufacturing of counterfeit cards. Criminals use technology to produce exact replicas of existing cards and to create fictitious payment cards from scratch. Previously counterfeit cards were usually manufactured using a silk screening process to duplicate the card logo and background onto a plain white plastic card. Advanced technology facilitates the manufacturing of counterfeit cards, complete with a hologram and fully encoded magnetic strip that is difficult to distinguish from the genuine bank payment card, through a multi-step process using computer equipment, embossers, laminators and tipping foil.

White plastic used for the manufacturing of bank payment cards is freely available and purchased for various legitimate purposes, such as access control at residential and business premises. A card encoder and appropriate software are used to encode the magnetic strip of the counterfeit card with the stolen data of the legitimately issued card and to re-encode the magnetic strip of stolen and lost cards. Various different embossing machines or embossers are available and used to convert the white plastic into a counterfeit card. The more recent models seized by the South African Police Services are modern and capable of producing an entire card, including trademark specific information.

Most embossing machines are imported. As with skimming devices the import of embossers is not regulated by South African legislation due to their widespread

[201] "Shoulder surfing" takes place when the fraudster acquires the PIN by covertly observing the legitimate cardholder entering his or her PIN, usually by looking over the victim's shoulder.

[202] Vrona "Automatic thieving machines: ATM frauds exposed" *The Kessler Report* 2006 vol 9 4.

[203] Hyland and Thornhill (ed) *Fraud Manager's Reference Guide* (2005) 169.

[204] A number of skimming devices retrieved by the South African Police Services contained data in the format of sound files, which is indicative of more advanced technology being introduced by the fraudsters.

legitimate use in the banking, retail and education industries. A tipper or automatic gilding press machine is used to tip and foil the embossed characters with gold or silver foil. The authentic appearance of the counterfeit card is further enhanced by the adding of the hologram and logo of the card association on the front of the card and a signature panel on the back. Holograms can be stolen, obtained from used cards, ordered online or bought from a corrupt employee at one of the legitimate card-manufacturing service providers,[205] while the logo can be scanned and printed if not stolen. Signature panels are purchased, scanned and printed or stolen.

Blank white plastic embossed and encoded with stolen account particulars can be used for fraudulent cash withdrawals at ATMs or purchases at merchants. The data of a single compromised card can be used to manufacture a number of counterfeit cards used by different runners or mules. This maximises the syndicate's ability to spend and/or draw cash before the compromise is detected and the card blocked in order to prevent further use.

#### 5.4.4 The tools of the trade

As is evident from the above description a variety of equipment is required to manufacture counterfeit payment cards. Adding to the complexity of the combating of this crime type is the fact that all of these tools are freely available. Due to the fact that cards are legitimately used for access control and monitoring of time and attendance and thus very common in South Africa,[206] equipment, such as white plastic issued with magnetic strips, magnetic card readers and encoders, is freely available, affordable and not regulated. Toolkits containing the said equipment are mostly purchased online and imported, while the white plastic and encoders are also locally available. When imported, the equipment is often dismantled, brought into the country purportedly as components of other equipment and reassembled, once collected by the fraudsters. The software required for downloading the data from the card readers or skimming devices is usually included in the toolkit, but can also be downloaded from the internet free of charge.

Although corruption is still occasionally being used as a method to obtain the required data or other necessities such as the logos, holograms and signature panels, the use of technology to achieve the same objectives is winning ground. This is no surprise since it is not only simpler, but the risk of being identified, arrested and prosecuted is significantly less. The availability and low cost of the tools of the trade has made this a relatively simple form of fraud of low risk to the fraudsters.

#### 5.4.5 Utilising counterfeit payment cards to obtain cash or merchandise

The objective of counterfeit card fraud is to obtain cash, alternatively merchandise.

One can safely assume that the ultimate objective of using counterfeit cards is for the criminals to *obtain cash*, which is not only used to pay the members of the syndicate for their contributions, but also for a variety of other purposes, including the facilitation of a number of other criminal activities such as drug and human trafficking.

[205] Wells *Encyclopedia of Fraud* Association of Certified Fraud Examiners Inc. Texas (2007) 271 states that Visa and MasterCard suffered losses in excess of $700 m in 1994 caused by one Chinese hologram-producing syndicate alone.

[206] Examples include secured residential areas, universities and most business premises.

When merchandise is purchased using counterfeit cards, the merchandise is usually sold to generate cash. "Friendly merchants" will accept a counterfeit card as method of payment and issue a receipt reflecting the purchase of some goods, usually electronic equipment, while handing the fraudster cash instead.

The easiest way of mitigating the risk of being identified and arrested when obtaining cash using a counterfeit bank card is, however, to draw cash from an ATM. When high-tech skimmers are used, the victim's PIN is copied at the same time as the track data on the magnetic strip. Subsequently manufactured counterfeit payment cards can thus immediately be used at a number of ATMs simultaneously to draw the money available in the customer's bank account. Using a counterfeit debit card, the fraudsters will have access to the overdraft facilities available to the account, whilst a counterfeit credit card will enable them to withdraw money against the credit limit extended to the card. The daily ATM withdrawal limit set by the bank in question will determine the maximum amount of cash that can be stolen in this manner from any targeted account in one day.

Although it has not yet been encountered locally, development of technology now seemingly also enables criminals to "convert skimmed cards into cash" without making a real purchase or drawing money from an ATM; all that is seemingly required is a credit card magnetic strip, the appropriate software and a laptop.

When used to *purchase merchandise*, an altered, re-embossed or re-encoded stolen card is easier to detect than a complete reproduction of a counterfeit card.[207] With the collusion of the retailer, referred to as a "friendly merchant", white plastic with only the details of a valid card being copied onto the magnetic strip is sometimes used to purchase merchandise.[208]

### 5.4.6 The perpetrators

The execution of the activities related to counterfeit card fraud involves various parties with different skills, roles and responsibilities and is perpetrated in an organised fashion.[209] Foreigners are mostly used to obtain the tools of the trade. The required equipment is currently mostly imported from Bulgaria.

So-called runners or mules are usually employed for both the initial and the final phases of the lifecycle, albeit different runners generally operate in each phase. Service staff such as waiters and cashiers are often recruited and issued with skimming devices. They are then paid to use the skimming devices to obtain the track data on the magnetic strip of legitimate payment cards received by them during the normal course of business. Runners are also recruited to install and remove high-tech skimming devices mounted at ATMs. Finally, runners are employed to use the manufactured counterfeit payment cards to generate cash for the syndicate as described above.

The back office responsibilities are executed by so-called intermediaries who are technologically skilled. They would typically be responsible for all the activities from downloading the data off the skimming devices up to manufacturing the final product, a counterfeit payment card ready for use.

[207] To mitigate related losses, bank investigators regularly provide retailers with training to detect counterfeit payment cards.

[208] Hyland and Thornhill *Fraud Manager's Reference Guide* (2005) 161.

[209] Wells (n 205) 580 adopts the Secret Service description of organised crime being "a loosely similar number of criminal groups, who sometimes cooperate with each other, and sometimes antagonize one another, but who generally conduct independent operations".

The risk of being identified and arrested is significantly larger for runners than for other members of the syndicate. Since the runners are easy to recruit, train and replace, their prosecution unfortunately does not disrupt the criminal activities of the syndicates behind this crime type.

## 6 *Conclusions and recommendations*

As stated by Skeen, "[e]very advance made by the inventive and idealistic mind is rivalled by parallel developments of the deceitful and criminal mentality. The computer is no exception".[210] The development of technology has provided previously unknown scope for the facilitation of fraud.[211] It has engendered new and more sophisticated forms of commercial crime and made the redistribution of the proceeds of crime quicker and more difficult to prevent and/or recover. Moreover, the almost endless new possibilities for misappropriating funds have been accompanied by a significant reduction in risk for the criminals stealing money and credit. "Card fraud and online identity theft are now arguably two of the fastest-growing computer crimes, facilitated by a combination of phishing and malware."[212]

The prevalence of card-skimming incidents and specifically incidents involving high-tech skimming devices, is concerning. Such arrests as have been made in relation to these offences have resulted in few prosecutions and mostly with insignificant sentences; this has had little if any deterring impact on a flourishing and very lucrative crime type. One therefore needs to ask the question whether the South African criminal law has kept up with these developments or whether it is rather the application of our criminal law which is in dire need of attention.

In his inaugural lecture as professor in criminal law on 24 April 2002, Burchell pointed out that activities where a computer is used as an instrument to commit crime might already be adequately covered by existing common-law crimes.[213] A typical example pertinent to the crimes under discussion is the use of a counterfeit card to steal money from a legitimate account holder or to defraud a bank or merchant through the drawing of cash at an ATM or the purchasing of merchandise. The common-law crimes of theft and fraud respectively sufficiently cater for these criminal activities.

During the same lecture Burchell warned against the so-called "blunderbuss" approach of simply resorting to the enactment of new offences rather than improving the detection and investigation of existing crimes:

> "Before succumbing to the crime-control model of criminal justice and developing new crimes to counter the ingenuity of the criminal mind, we need to answer two questions: (a) has a thorough and creative examination been done to determine whether the existing common or statutory law is inadequate to deal with the new or revived nefarious manifestation; and (b) does the cost in human and financial terms warrant the intervention of legislation, diverting already limited resources from the detection and prosecution of common-law crimes of violence to special and costly forms of law enforcement and to defending potentially time-consuming constitutional challenges to the legislation?"[214]

[210] Skeen "Computers and crime" 1984 *SACC* 262.
[211] Wilson "Cybercrime in the private sector: partnerships between the private sector and law enforcement" 2006 *Australian Law Journal* 694.
[212] Rowland *et al Information Technology Law* (2012) 103.
[213] "Criminal justice at the crossroads" 2002 *SALJ* 579.
[214] Burchell (n 213) 585.

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It is apparent from the discussion above that the South African law does, to a large extent, deal with counterfeit card fraud and that the focus should be on the effective application thereof by law enforcement agencies to ensure successful investigations and prosecutions. To ensure that fraudsters lose their appetite for this type of crime, it is, however, necessary for all the unlawful activities in the business value chain of counterfeit card fraud to be criminalised. Intervention by the legislature is thus necessary to facilitate prosecution of unlawful activities outside the ambit of the South African criminal law.

The criminalisation of the unlawful acquisition, possession, distribution and utilisation of all equipment required for the manufacturing of counterfeit payment cards (other than high-tech skimming devices and pinhole cameras which are already covered by both the ECT Act and RICA) will thus be a welcome addition to our law.

One can foresee difficulties in trying to prove the required intent if especially the acquisition, possession, and distribution of devices such as encoders, embossers and tippers are criminalised. The inclusion of presumptions in the related legislation should thus be considered to facilitate such prosecutions. However, it is unlikely that a clause placing the burden of proof on the accused will pass constitutional muster.[215] It is thus recommended that the presumptions be formalised with a clear consideration for the criteria that have crystallised throughout the various relevant constitutional decisions.[216] In essence the broad objective of the reverse onus, namely the effective prosecution of crime, will only be considered sufficiently important if it can be shown that there is a pressing social need for the effective prosecution of the category of offences to which the presumption applies.[217]

There are, furthermore, a number of areas in respect of which offences created in legislation could be formulated with greater clarity and precision to either specifically deal with counterfeit card fraud or to provide for clearer and more understandable descriptions of devices used to access, copy and store data required for the manufacturing of counterfeit cards. It should not be necessary for prosecutors to force the facts of a case into the language of legislation that was clearly not designed to accommodate them.[218] Notwithstanding the fact that it would be appropriate to expand and develop the interpretation of the existing South African criminal law in such a way as to take account of advances in technology and its use, such modification has to remain consonant with the elements of the alleged offence; the law should not be stretched beyond its breaking point.[219]

At present South Africa does not have any statutory provisions dealing with the manufacturing, possession and use of counterfeit payment cards similar to the simple and straightforward provisions in respect of counterfeit coin and bank notes provided for in the Prevention of Counterfeiting of Currency Act and the

[215] See *Zuma* 1995 2 SA 642 (CC) where the constitutional court found s 217(1)(b)(ii) of the Criminal Procedure Act to be unconstitutional in that by placing the burden of proving the absence of voluntariness on the accused, it violated the presumption of innocence.

[216] *Zuma* (n 215); *Coetzee* 1997 3 SA 527 (CC); *Mbatha; Prinsloo* 1996 1 SACR 371 (CC); *Scagell v Attorney-General of the Western Cape* 1996 2 SACR 579 (CC); *Meaker* 1998 3 SACR 73 (W) and *Manamela* 2000 1 SACR 414 (CC). For a discussion on the infringement of the presumption of innocence see Schwikkard and Van der Merwe *Principles of Evidence* (2010) 514 ff.

[217] Schwikkard and Van der Merwe (n 216) 518 and *Scagell v Attorney-General of the Western Cape* (n 216) par 74.

[218] An example of this is the use of RICA to prosecute the possession and use of skimming devices.

[219] Rowland *et al Information Technology Law* (2012) 115.

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South African Reserve Bank Act. This will, however, now be rectified with the introduction of the Cybercrime and Cybersecurity Bill. The prevalence of this type of fraud, its impact on the community and the threat it poses to the economy, coupled with the challenges encountered during the investigation and prosecution thereof, clearly made the new proposals long overdue.

There was also a dire need for the revision of the penalty provision in the ECT Act. As it stands criminals are not distressed; they are merely inconvenienced. Harsher penalties are required to deter counterfeit card fraudsters and other cyber criminals. As stated by Langa J: "[d]eterrence is, obviously, a legitimate objective which the state may pursue. We live in a crime-ridden society; the courts and other relevant organs of the state have a duty to make crime unattractive to those who are inclined to embark on that course."[220] As mentioned earlier, there is also a glaring disconnect between the sentences provided for in the ECT Act and those contained in legislation such as RICA and especially POCA.

One of the questions Burchell advocates worthy of consideration before deciding to develop new crimes to counter the ingenuity of the criminal mind, is whether the cost in human and financial terms warrants it.[221] The significant increase in the losses suffered as a result of counterfeit card fraud seems rather persuasive. Collier argues that the evolution of technology leaves no option but for the law to evolve itself in this regard.[222]

The emphasis of the Roman-Dutch law on tangibles lies at the roots of this struggle to apply our criminal law to intangibles such as data and information.[223] In our view the theft of data and information should be recognised in our law with its own *sui generis* principles and requirements similar to the theft of credit. The legislature's silence on the issue of theft and/or the unlawful copying of data and information seemingly leaves this aspect to the judiciary. An analysis of the law relating to the theft of credit leaves no doubt that our law has developed to the extent that the theft of incorporeal things is recognised.[224] The constitutional principle of legality will in all likelihood render our courts hesitant to develop the law much further in this regard. The endemic nature of criminal activity in this field, together with the social impact of this type of crime, make the time ripe for the legislature to intervene by means of a statutory provision in order to criminalise unauthorised copying and use of data and other information, as was previously done with the introduction of new offences related to, but not covered by, the common-law offence of theft.[225]

As the development of technology inspires more creative methods of accessing personal data and committing related crimes more speedily under a digital veil of anonymity, the timely detection and successful investigation of identity theft will become even harder. This will inevitably cause this already rampant phenomenon to proliferate even further. It is consequently recommended that the South African

220 *Williams* 1995 3 SA 632 (CC) par 80.
221 (n 216) 585.
222 Collier in Buys (ed) (n 165) 322.
223 Van der Merwe "Computer crime- recent national and international developments" 2003 *THRHR* 30 43.
224 Snyman "Die gemeenregtelike vermoënsmisdade en die eise van ons moderne samelewing" 1977 *SACC* 11 14 refers to this development of the common law as "'n broodnodige aanpassing van ons gemenereg by die besondere behoeftes van ons tyd".
225 Examples of this include s 1 of the General Law Amendment Act 50 of 1956 and s 36 of the General Law Amendment Act 62 of 1955.

legislature follow international example by creating a statutory offence of identity theft.

Regardless of whether such proposed legislation is enacted, there still remain underutilised avenues to harness existing legislation against the offences we have discussed. For the fight against counterfeit card fraud to succeed it is vital for investigators and prosecutors to refrain from accepting pleas on statutory offences and unsatisfactory sentences. Instead, where supported by the evidence, reliance should be placed on common-law offences of fraud and theft, the doctrine of common purpose and conspiracy, and proving the organised nature of the crime, or, where appropriate, on racketeering charges provided for in POCA. Charges under the ECT Act and RICA should, where possible, only be used as alternative. Where appropriate, perpetrators should also be charged with other relevant statutory offences such as contraventions of the Immigration Act, the Identification Act and the Customs and Excise Act. Effective investigations and prosecutions will ensure suitable sentences. This will go a long way towards combating this global phenomenon and threat to our economy.

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# *Nkata v Firstrand Bank Ltd* [2016] ZACC 12 (21 April 2016) and its impact on reinstatement of credit agreements governed by the National Credit Act 34 of 2005

CORLIA VAN HEERDEN*

## 1 *Introduction*

When the National Credit Act[1] came into full effective operation in 2007 scant attention was paid to its provisions in section 129 relating to reinstatement of a credit agreement which provided as follows:

> "(3) Subject to subsection (4) a consumer may-
>
> (a) at any time before the credit provider has cancelled the agreement re-instate a credit agreement that is in default by paying to the credit provider all amounts that are overdue, together with the credit provider's permitted default charges and reasonable costs of enforcing the agreement up to the time of its reinstatement, and-
>
> (b) after complying with paragraph (a), may resume possession of any property that had been repossessed by the credit provider pursuant to an attachment order.
>
> (4) A consumer may not re-instate a credit agreement after-
>
> (a) the sale of any property pursuant to –
>
> (i) an attachment order; or
>
> (ii) surrender of property in terms of section 127;
>
> (b) the execution of any other court order enforcing that agreement; or
>
> (c) the termination thereof in accordance with section 123."

Some authors commented on the vagueness of the section, such as Otto, who remarked that it was incomprehensible how a credit agreement that had not been cancelled could be reinstated,[2] but in general sections 129(3) and (4) did not attract much attention in the early years of the NCA. From 2009 onwards cases started being reported.[3] However the full complexity of these provisions was revealed

* Absa Chair in Banking Law in Africa; Professor, Department of Mercantile Law, University of Pretoria.

1 National Credit Act 34 of 2005 (hereinafter also referred to as the NCA or Act).

2 Otto *The National Credit Act Explained* (2006) 89. See also Coetzee "Voluntary surrender, repossession and reinstatement in terms of the National Credit Act 34 of 2005" (2010) 73 *THRHR* 569-588; Brits "Purging mortgage default: comments on the right to reinstate credit agreements in terms of the National Credit Act" (2013) 24 *Stell LR* 165-184; Steyn "Reinstatement of a home mortgage bond by paying the arrears: the need for appropriate legislative reform" (2015) 26 *Stell LR* 132-155: Otto & Otto *The National Credit Act Explained (*2016) 130-131.

3 *Nedbank Ltd v Barnard* (2009) *ZAECPEHC* 45 (1 September 2009) par 14-15; *Firstrand Bank Ltd formerly known as First National Bank of Southern African Ltd v Fester* (2011) ZAWCHC 363 (15 September 2011) par 4; *Dwenga v First Rand Bank Ltd* (2011) ZAECELLC 13 (29 November 2011) par 21-23, 34-35 (fnn 35-36); *Nedbank Ltd v Fraser and Four Other Cases* 2011 4 SA 363 (GSJ) par 39-42; *Firstrand Bank Ltd v Britz* (2012) ZAFSHC 13 (9 February 2012) par 22, 26; *ABSA Bank Ltd v Morrison* 2013 5 SA 199 (GSJ) par 23-27.



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in *Nkata v Firstrand Bank Ltd,*[4] a matter that initially served before the High Court and thereafter went on appeal before the Supreme Court of Appeal,[5] and subsequently served before the Constitutional Court.[6]

The purpose of this contribution is to consider the impact of the majority judgment by the Constitutional Court in the *Nkata* case on the reinstatement of credit agreements in accordance with section 129(3) and (4) in their original format, as well as its impact, if any, in the context of section 129(3) and (4) as subsequently amended by the National Credit Amendment Act,[7] and to consider how to deal with the effects of the said judgment practically pending possible further amendment of section 129(3) and (4), or the possibility of the Constitutional Court ruling on the issue of reinstatement again in future.

To contextualize the discussion the facts of the *Nkata*-matter will be provided as well as a brief overview of relevant aspects of the findings of the High Court and Supreme Court of Appeal. Thereafter the majority judgment of the Constitutional Court will be set out, together with the dissenting judgments of Cameron J and Nugent J, the latter merely to present a juxtaposed view of the majority's judgment.

## 2 *The facts*

Mrs Nkata, a businesswoman who sells hospital equipment, bought a property at 35 Vin Doux Crescent, Durmonte, Durbanville, Western Cape in March 2005. In 2005 and 2006 respectively, she registered two mortgage bonds with Firstrand Bank to finance the acquisition. The first mortgage bond was for R850 000 and the second mortgage bond was for R630 000. For the first bond she selected the address of the property as domicilium address for all notices but for the second bond she selected C/04 Devonshire Hill, Rondebosch, Cape Town being the address where she temporarily lived while her house was being built on the property (and which house became her primary residence in 2007). She was, however, unable to meet her obligations under the mortgage agreement and repeatedly fell into arrears, eliciting many phone calls and letters from the bank, including two section 129(1)(a) notices. Unfortunately, both section 129(1)(a) notices were incorrectly addressed and Mrs Nkata never received them. In the meantime the bond arrears were mounting up and on 5 July 2010 the bank issued summons which was eventually served (by affixing) at the correct address but to which Mrs Nkata did not enter appearance to defend as she later maintained that the summons was never served on her. On 29 September 2010 default judgment was granted against her for the total outstanding amount owing to the bank and a writ of execution for the attachment of the property was issued. Mrs Nkata claimed that she became aware of the judgment only when a legal representative from the bank telephoned to inform her that her property was to be sold in execution by public auction on 10 December 2010. On 19 November 2010 she urgently applied to the High Court for rescission of the judgment. Before the application was heard, however, she entered into a settlement agreement with the bank and agreed to pay monthly instalments of R10 000. The bank cancelled the sale of the property but in the settlement agreement it was agreed that if she failed to pay the monthly instalments of R10 000, the bank

[4] *Nkata v Firstrand Bank Ltd* 2014 2 SA 412 (WCC).
[5] *Firstrand Bank Ltd v Nkata* 2015 4 SA 417 (SCA).
[6] *Nkata v Firstrand Bank Ltd* (2016) ZACC 12 (21 April 2016).
[7] National Credit Amendment Act 19 of 2014 that came into operation on 13 March 2015.

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would be entitled to sell the property in execution forthwith. She also agreed to pay the costs of the cancelled sale as well as the rescission application "as taxed or agreed". The settlement agreement was never made an order of court. Mrs Nkata paid the arrears (but not the legal costs of enforcing the credit agreement which was debited to her account in February 2011 in addition to legal costs debited earlier) on 7/8 March 2011. After paying the full arrears on her account in March 2011, Mrs Nkata again fell behind in her payments. She brought her account up to date again in March 2012, and again in May 2012. In the meantime she tried to have the default judgment rescinded. The bank refused to agree to the rescission. She also made a distressed debt application which the bank rejected since the matter was "under litigation". Her arrears on her bond account escalated and the bank put the property up for sale in execution again – this time for 24 April 2013 at which auction the property was sold to a third party. (On 1 March 2013 the bank had debited legal fees in respect of the sale in execution to Mrs Nkata's bond account). At the end of April 2013 Mrs Nkata and the purchaser of the property entered into a lease agreement allowing her to remain in the property pending its renovation and on-sale.[8]

### 3 *The High Court Judgment*

In May 2013 Mrs Nkata again approached the High Court seeking to rescind the default judgment that had been granted against her. Transfer and registration of the property to the new owner who bought the property on auction was suspended pending the outcome of the rescission application. Despite finding that Mrs Nkata had a bona fide defence (due to non-compliance by the bank with section 129(1)(a) given that the notices were incorrectly addressed) the High Court refused to rescind the default judgment because Mrs Nkata had no satisfactory explanation for why she delayed her application for nearly two and a half years after learning of the judgment and also because she settled her dispute with the bank when she entered into the settlement agreement on 10 December 2010 as a result whereof the court held that she had preempted her right to set aside the judgment.[9]

However, although it rejected the rescission application the High Court *suo motu* raised the issue of reinstatement under section 129(3). It subsequently held that Mrs Nkata's payment in March 2011 wiped out her arrears and reinstated the credit agreement. The court found that reinstatement after falling into arrears does not require payment of the full accelerated debt but only payment of the arrears.[10] Further it was common cause that the bank had not cancelled Mrs Nkata's agreement, thus the agreement was eligible for reinstatement (based on the requirement in section 129(3) that reinstatement has to occur *before* cancellation).[11] The High Court further indicated that the bank had debited Mrs Nkata's account with various charges relating to costs. However, it held that the bank could not impose these costs without such costs "being taxed or agreed". It further held that by debiting the legal costs to Mrs Nkata's account, rather than demanding separate

[8] summary of facts as provided by Cameron J in *Nkata v Firstrand Bank Ltd* (2016) ZACC 12 (21 April 2016) par 3 to 16.

[9] as relayed by Cameron J at par 18 and 19. It is to be noted that the High Court referred with approval to the discussion by Brits "Purging mortgage default: comments on the right to reinstate credit agreements in terms of the National Credit Act" 2013 24 *Stell LR* 165.

[10] par 38 of the High Court judgment.

[11] par 39 of the High Court judgment.

payment, the bank indicated to her that it was "content to lend the corresponding amount to the consumer and to receive payment thereof in instalments as if the debited costs were part of the capital". Thus, although Mrs Nkata never paid these legal costs, the High Court was satisfied that the fact that she paid the arrears on the agreement was sufficient to meet the requirements of section 129(3)(a).[12]

The High Court further held that Mrs Nkata did not have to intend to reinstate her credit agreement or signal to the bank any intention to do so as "reinstatement occurs by operation of law if the consumer as a fact makes the payments contemplated by section 129(3), unless reinstatement is precluded by virtue of section 129(4)".[13] Accordingly, although the judgment stood, it could no longer be enforced against Mrs Nkata because she had already reinstated her agreement before the judgment was executed. The High Court thus set aside the sale of the property.[14]

## 4 *The Supreme Court of Appeal judgment*

The Supreme Court of Appeal found that the bank had already executed the default judgment by the time Mrs Nkata paid her arrears. It held that this execution occurred when the property was sold at the sale in execution. The Supreme Court of Appeal further found that reinstatement of a credit agreement implies an amendment to the agreement which, in terms of the NCA, demands the formality of being recorded in writing and signed. It thus held that as this formality was not complied with, reinstatement *in casu* was not competent.[15]

## 5 *The Constitutional Court Judgment*

The Constitutional Court judgment[16] that dealt with section 129(3) and (4) prior to their amendment by the National Credit Amendment Act, was delivered on 21 April 2016 and consisted of four separate judgments: a main judgment by Cameron J, a majority judgment by Moseneke J with whom six other judges concurred, a separate judgment by Nugent J who in principle agreed with Cameron J's findings and a separate judgment by Jaftha J who concurred with the judgment of the majority but on different grounds. At the outset it should be noted that the Constitutional Court pointed out that the finding of the Supreme Court of Appeal that reinstatement did not occur because it was barred by the sale of the property was wrong in view of the fact that the property was only sold in April 2013 whereas Mrs Nkata had already paid her arrears on her mortgage agreement in March 2011.[17] The Constitutional Court thus did not concern itself much with the Supreme Court of Appeal's judgment but more with the judgment of the High Court.

Moseneke DCJ delivered the majority judgment. In his interpretation of section 129(3) he singled out two purposes of the National Credit Act, namely promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers and addressing and correcting imbalances

[12] par 42 to 44 of the High Court judgment.

[13] par 45 of the High Court judgment.

[14] See par 46 to 54 regarding the court's interpretation of "attachment order" and "execution".

[15] as relayed by Cameron J in *Nkata v Firstrand Bank Ltd* (2016) ZACC 12 (21 April 2016) par 28 and 29.

[16] (2016) ZACC 12 (21 April 2016). SERI (The Socio-Economic Rights Institute) participated as amicus curiae.

[17] par 29.

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in negotiating power between consumers and credit providers[18] He stated that sections 129(3) and (4) have introduced a *novel* relief of reinstatement, which parts ways with the debt collection measures of old. The relief is available when a credit agreement is in default but has not been cancelled by the credit provider. Once the consumer makes specified overdue payments, the agreement is reinstated and the consumer may resume possession of the property that has been repossessed by the credit provider under an attachment order. He remarked that the evident purpose of section 129(3) is to urge consumers to pay their overdue amounts, default charges and legal costs to their lenders, and in turn, consumers "in good standing" are rewarded with reinstatement of the credit agreement and the return of their attached property.[19]

Moseneke DCJ observed that it in terms of section 129(3) and (4) it is the consumer who may reinstate a credit agreement. In this regard he remarked: "So, as long as the agreement is current, she may elect to reinstate it. The clear import is that for purposes of reinstatement the consumer is the protagonist. She may disclose the design to the credit provider but she is not compelled to give notice to or seek the consent or cooperation of the credit provider."[20] He agreed with the High Court that the consumer may reinstate the credit agreement by operation of law.[21] According to Moseneke DCJ reading in a requirement of prior notice to the credit provider as well as a reinstatement that does not occur automatically against due payment, would unduly limit the value to the consumer of the remedy of reinstatement, and it would "unduly diminish the usefulness of the relief of reinstatement if the consumer were saddled with procedural requirements most consumers are likely to falter on".[22]

On the question as to the meaning of "all amounts that are overdue" he referred to the fact that mortgage bonds contain acceleration clauses and agreed with the High Court that only the arrear amounts and not the full accelerated debt needed to be paid in order to effect reinstatement.[23] Moseneke DCJ further indicated that the question arises whether, when the bank invokes an acceleration clause, it has "for that reason only" cancelled the agreement. He remarked that this is a mixed question of fact and law and stated "[I]f the acceleration clause is resorted to while the contract subsists and the bank demands full payment it is not the same thing as cancellation of the agreement for breach. This is so if we keep in mind that section 129(3) applies to agreements in default. Here the bank could only lawfully have

[18] par 93 to 99 with reference to s 3(e) of the NCA. He referred to the observation by Cameron J in *Sebola and Another v Standard Bank of South Africa Ltd and Another* 2012 5 SA 412 (CC), in the context of section 129(1)(a), that at the core of the Act is the objective to protect consumers and that this protection should be balanced against the interests of credit providers and should not stifle a "competitive, sustainable, responsible, efficient [and] effective credit market and industry. He further indicated that the purposes of the Act are directly attributable to the constitutional values of fairness and equality (with reference to n 22 of *Sebola*). He also referred to *Kubyana v Standard Bank of South Africa Ltd* 2014 3 SA 56 (CC) where the court relied on *Sebola* to make the point that s 129(1) aspires "to facilitate the consensual resolution of 'credit agreement disputes'" and *Ferris v Firstrand Bank Ltd* 2014 3 SA 39 (CC) that held that the good faith negotiations required by s 86(5) in an application for debt review were aimed at "the parties reaching an agreement *before* the need for a debt–restructuring order."

[19] par 100.

[20] par 104.

[21] par 105.

[22] ibid.

[23] par 107 and 108.

terminated the credit agreements in terms of section 130 read with section 129. At a factual level the bank did not comply with section 129. This meant that the credit agreements were not cancelled."[24]

As regards the arrear legal costs Moseneke DCJ indicated that these costs were not presented to the consumer but debited against her bond account and she was not "invited" by the bank to pay them – it never gave her a separate notice of the legal costs or demanded their payment. Thus it could be asked whether the costs that were debited to the consumer's account for legal costs formed part of "permitted default charges and reasonable costs of enforcing the agreement up to the time of reinstatement".[25] Moseneke DCJ referred to the fact that the High Court noted that the consumer could not be expected to take proactive steps to find out what the costs would be for reinstatement to be effected. Neither could a consumer be expected to start taxation or agree with the credit provider on the quantification of these costs. The credit provider is required to take the appropriate steps if it wants to recover the costs for enforcing an agreement with the consumer.[26] However, he remarked that the High Court indicated that the bank chose to "happily capitalise" the legal costs as a result whereof the High Court found that the costs debited to the consumer's account lost their separate character as costs enforcing the agreement.[27] According to Moseneke DCJ there was much to be said for the High Court's reasoning that by debiting the consumer's account instead of separately demanding the payment of legal costs, the bank was satisfied with receiving those amounts in instalments and that for purposes of section 129(3) the costs debited to her account lost their separate character as enforcement costs. However, Moseneke DCJ did not regard it necessary to reach "as firm a conclusion" on this point as the High Court did.[28]

Thus, the majority found that the credit agreement was reinstated when the consumer settled her bond arrears some time prior to the sale in execution and that at that time the bank's legal costs were not due and payable because it had not given the consumer notice of the nature and extent of the legal costs and had not demanded payment of same from her and also the legal costs were not shown to be reasonable.[29] It agreed with the High Court that the consumer could not be expected to take pro-active steps to find out what the costs would be for reinstatement to be effected and that a consumer could not be expected to start taxation or agree with the credit provider on the quantification of these costs. It held that the credit provider is required to take the appropriate steps if it wants to recover the costs for enforcing an agreement with the consumer.[30] In this regard

[24] par 110.

[25] par 113 and 114. Moseneke DCJ stated: "After she had paid the arrears in March 2011 and again in March 2012, the Bank regarded her as 'up to date' with her payments. The Court found that the Bank was satisfied with settling the costs by lending Mrs Nkata the money for legal costs as they simply debited her bond account with the money and did not bring it to her attention or invite her to pay it. Before us these factual findings were never impugned. If anything, they are consistent with the pleadings."

[26] par 116.

[27] par 117.

[28] par 120. He remarked that in doing so he avoided the "dilatory controversy" mooted in the main judgment that the bank has not been shown to have waived its right to receive payment of legal costs under s 129(3). He further stated: "Even more importantly, the dispute may be resolved on another and perhaps clearer basis."

[29] par 121. Moseneke DCJ stated that "[I]nstead the Bank chose to be the sole arbiter of the extent of the legal costs and one-sidedly debited the costs against the bond account of Mrs Nkata."

[30] par 122.

Moseneke DCJ remarked: ”[t]he Bank knows well that it is entitled to reasonable costs only. It must take steps to place its legal costs within this statutory pigeon hole.” He accordingly declared that “[P]roperly understood, section 129(3) does not preclude the reinstatement of a credit agreement where the consumer has paid all the amounts that were overdue but has not been given due notice of the reasonable legal costs, whether agreed or taxed, of enforcing the agreement. The legal costs would become due and payable only when they are reasonable, agreed or taxed, and on due notice to the consumer.”[31] According to the majority this is clear from a simple reading of section 129(3), which provides that the agreement is reinstated by the consumer by paying the credit provider “all amounts that are overdue *together* with the credit provider’s permitted default charges *and* reasonable costs of enforcing the agreement up to the time of reinstatement”. It indicated that the words “together” and “and” make it clear that three distinct requirements are imposed on a consumer before a credit agreement is reinstated. By requiring a credit provider to demand separately payment of the reasonable costs of enforcing the agreement, the Act “imposes a more transparent practice of billing – one which is in line with the purposes of the Act”. Thus, it held that the bank should have demanded payment of the reasonable costs of enforcing the agreement separately from the consumer’s arrears and brought it to her attention.[32]

Moseneke DCJ stated that the aforesaid interpretation of section 129(3) gives better effect to the clear purpose and text of section 129(3) because if a credit provider is not obliged properly to quantify and give due notice of the legal costs to the consumer, the relief section 129(3) affords to a consumer will be frustrated and become illusory.[33]

Upon having found that the agreement was indeed reinstated the majority subsequently considered whether such reinstatement occurred before the cut-off point listed in section 129(4)(b). It referred to the High Court that held that the bar to a reinstatement occurs only when the proceeds from a sale in execution have been realised and that on the facts in this case the default judgment obtained against the consumer did not constitute an attachment order against the property nor did the default judgment acquire that character when the bank obtained a writ of execution against the consumer’s mortgaged property.[34] Moseneke DCJ pointed out that the bank challenged this interpretation with the contention that “execution” does not only refer to the completed act of execution, but also to the process of execution and that the High Court should have interpreted “execution” broadly to include all the steps that were taken to attach the property.[35] He held, however, that there is no compelling reason why the meaning of “execution” should be given the extended meaning preferred by the bank and that an extended meaning would render section 129(4)(b) “unuseful”.[36] He stated that the High Court was correct that the barrier to a “revival” of the credit agreement applies only when proceeds from a sale in execution have been realised because only then

[31] par 124.
[32] ibid.
[33] par 125. Moseneke DCJ remarked that it will always be open to the credit provider to thwart a reinstatement by simply asserting that the legal costs unilaterally debited to the bond account had not been paid.
[34] par 129.
[35] par 131.
[36] The majority did not elaborate on what it meant by “unuseful.”

would the "revival" be of no use to either party.[37] According to him section 129(3) amounts to "a statutory remedy for rendering a default judgment and attachment order ineffectual".[38] He stated that that explains why once the credit agreement has been reinstated by paying all overdue amounts and allied administrative and legal costs, the consumer "may resume possession of any property that had been repossessed by the credit provider. This plainly means that the default judgment and subsequent attachment would be rendered without force or effect."[39]

He further pointed out that the bank had contended that when a judgment creditor attaches goods, he obtains a real right in respect of those goods because the attachment of property in execution creates a judicial mortgage. However, he remarked that this argument is "at odds with the ordinary, contextual and purposive meaning of sections 129(3)(a) and (b). The common law judicial mortgage the Bank has in mind, in this context, has been superseded by the design of section 129(3)."[40]

Moseneke DCJ indicated that there was another decisive reason why the High Court was right: "Had the property been sold in execution following an attachment order, the execution would not have stopped the reinstatement because the sale in execution took place in April 2013 – just over two years *after* Ms Nkata cleared her arrears for the first time in 2011."[41] He thus held that although there had been an attachment of the property no sale in execution occurred and no proceeds of the sale were realised at any time before the consumer cleared her arrears in 2011. She was thus entitled to "revive" the credit agreement that the credit provider had not cancelled and she did this by "purging her default in full" as she paid the credit provider all amounts that were then overdue together with default charges. He agreed with the High Court that the consumer had successfully reinstated the credit agreement when she settled the full bond arrears on 8 March 2011 and stated that at that stage the bank's legal costs were not due and payable because the bank had not given the consumer notice of the legal costs. He remarked: "It had not demanded payment properly or at all. Also the nature of the legal costs had not been agreed to by Mrs Nkata and had not been assessed for reasonableness by taxation or other acceptable means." He thus held that, properly constructed, section 129(3) does not preclude the reinstatement of a credit agreement where the consumer has paid all the amounts that are overdue, but has not been given due notice of reasonable legal costs (whether agreed or taxed) of recovering the bond arrears. He stated that this must be so because the legal costs would become due and payable only when they

[37] ibid.
[38] ibid.
[39] ibid.
[40] par 132. Moseneke DCJ stated further (par 133) with reference to the settlement agreement between the parties entered into in December 2010, that the bank accepted, in its words, "[i]n the event that the arrears are now paid, the Bank cancels the sale in execution, the agreement continues and the defendants retain their immovable property." However, the bank steadfastly maintained that "[i]f the defendants again [fell] into arrears, the Bank, as it is entitled to do, [may instruct] its attorneys to reschedule a sale in execution." He indicated that before the court the bank fell on these facts to buttress its stance by arguing that here the reinstatement would still be precluded as the settlement agreement reached between the parties on 10 December 2010, which was entered into long before the settlement of the arrears, reserved the bank's right to sell the property. However, Moseneke DCJ indicated that this argument too could not be upheld because clause 5 of the settlement agreement stated that "[s]hould [Ms Nkata] pay the full arrears…the [bank] shall not sell the property in execution but [Ms Nkata] shall pay the full monthly instalments to the Bank" – thus not even the terms of the settlement agreement entitled the bank to seek to sell the property without more.
[41] author's emphasis.

are reasonable, agreed or taxed and on due notice to the consumer. Consequently Moseneke DCJ held that for these reasons the High Court was correct when it ordered that the default judgment and the writ of execution ceased by operation of law to have any force or effect as from 8 March 2011.[42]

Cameron J, in a separate judgment, dealt with what is meant by section 129(3) when it says a creditor (sic) may reinstate the credit agreement that is in default by "paying" the credit provider's reasonable costs of enforcing the agreement.[43] He pointed out that the High Court held that when the bank debited its legal fees to the consumer's account, it was "content to settle" those costs "by lending her the money through a debit on her bond account".[44] According to him the High Court's approach means that in effect the enforcement costs the consumer must pay to achieve reinstatement are only "those costs of which the credit provider is at that time requiring payment". He remarked that such approach is not correct as it fails to give force to the clear wording of section 129(3). The mere fact that the bank's debit to the consumer's account showed that it was happy to add those costs to the capital debt for her settlement did not mean that "it accepted that she had paid those costs, or that she in fact did".[45] He remarked that, differently put, the question is whether adding a debit to a debtor's total outstanding debt constitutes payment for purposes of section 129(3) and pointed out that "payment" has always been understood in our law to mean "the delivery of what is owed by a person competent to deliver to a person competent to receive". Thus payment means "the satisfaction or performance" of an obligation and does not mean a promise to pay later or postponing payment by adding it to an already outstanding debt. By debiting the costs to her bond account the bank agreed to allow the consumer to pay her debts – it did not agree that she did not need to pay them or that she had already paid them. He stated that by adding those costs to the capital debt, the bank lent her money, thereby prescribing the manner in which it expected to receive payment. However, the bank's action in postponing its claim to payment did not mean that she paid those costs and the High Court was incorrect to conclude that it did.

Cameron J regarded as tenuous the contention by the consumer that reinstatement could occur once the parties, by "quasi-mutual assent", agreed that payment would be effected as part of the total capital payment, followed by monthly instalments (hence no separate payment is required to effect reinstatement under section 129(3)).[46] He indicated that accepting such contention would require the court to conclude that in debiting the consumer's bond account the bank made a tacit representation that it waived its right to receive full payment. According to him this argument could not be sustained because had the legislature meant that the consumer can make payment by agreeing to postpone payment, it would have said so – and it did not. He pointed out that the section states that reinstatement can be effected by "paying" the costs in issue: "this requires advance, not postponed, and complete, not partial, payment". Thus, he held that the consumer did not

[42] par 136 and 137. See also par 79 where the finding of the majority is summarized at the commencement of Moseneke DCJ's judgment.
[43] Clearly he meant "consumer" instead of "creditor".
[44] par 45.
[45] par 47 to 49.
[46] par 50. The consumer's contention was that once the first instalment was paid – contributing in some measure, however small, to repayment of the items that were debited against the consumer's account – then reinstatement could occur.

successfully reinstate the credit agreement since she failed to pay all the amounts that section 129(3) requires.[47]

He referred to the majority judgment and pointed out that he agreed with the majority that the NCA's express objectives mean that a correct interpretation of section 129 is one that strikes an appropriate balance between the competing interests of parties to a credit agreement. However, he disagreed with the majority's finding and pointed out that the bank did not "want to recover the costs of enforcing the agreement from the consumer" at all but that it was quite content to capitalize those costs for the convenience of itself and the consumer. Thus he asked: "Whyever should it have to be obliged to initiate the process of quantifying the unpaid additional costs when Ms Nkata was the one seeking to rely on reinstatement?"[48]

Cameron J further pointed out that the Act states that the consumer, and not the credit provider, must pay the outstanding sums and it imposes no obligation on the credit provider to take steps to recover the costs of enforcing the credit agreement – hence the credit provider does not have to do anything. He stated that the same applies to whether the costs the bank added to the consumer's account were "reasonable" – it was up to the consumer to complain that the amount was not reasonable but she never objected.[49] He concluded that the consumer sought to escape the duty the Act imposes on her of "paying" the charges in issue by saying that those charges were not taxed or established as reasonable – owever to uphold such a conclusion "seems to me to forfeit the balance that our precedents on the NCA requires us to maintain".[50]

He subsequently stated that section 129(3) has drastically changed the historical position that creditors to whom properties were mortgaged were contractually entitled to refuse late payments of home loans and that only payment of the full accelerated amount (not just the arrears) would save a mortgagee's property[51] by offering a consumer in dire circumstances a "lifeline" and protecting consumers who face the sale in execution of their properties by allowing them to reverse the credit provider's election to foreclose. However, the section does so on conditions namely that the consumer must fulfil the requirements for reinstatement and thus, simply bringing arrear bond instalments up to date is not enough. He further remarked that section 129(3) is specifically designed to counter the harsh effects of an acceleration clause and that it "makes good sense – and just sense" for the consumer to bear the responsibility of initiating the process and taking the necessary steps, including those required to pay the enforcement costs.[52] According

[47] par 51 to 53.
[48] par 55.
[49] par 56 and 57. He pointed out that the Act provides that the consumer can attain reinstatement "by paying" the costs and thus that it was for her to try and determine what was reasonable in order to achieve reinstatement. He indicated that the Act does not provide that the bank must establish that the costs are reasonable to ward off reinstatement.
[50] par 58.
[51] This refers to the common-law remedy of redemption. See Brits (n 9) 165.
[52] par 60. Cameron J remarked (par 61) that this approach does not render the Act's protection of consumers nugatory but simply sustains the balance the Act itself imposes. He indicated that the circumstances of the consumer in this case should be balanced against the risks and costs to credit providers, and, ultimately, the increased cost to those seeking to enter the credit market. Many less affluent than this consumer, who could not contemplate acquiring a second property as she did, might not be able to afford to acquire property at all if the cost of bond credit rose unduly because affording her reinstatements on the facts of this particular matter will surely increase that cost.

to Cameron J the requirement that a consumer may reinstate a credit agreement only "by paying" certain specified items undoubtedly seeks to protect a credit provider who has taken steps after a consumer has defaulted under a credit agreement – thus meaning that the bank had a right to receive the payments specified in section 129(3) before the credit agreement could be reinstated. He further held that the Act does not require the bank to demand payment of the costs section 129(3) lists but only requires the consumer to pay them in order to reinstate the agreement; hence the consumer had to pay those costs or at least tender payment thereof.[53]

In view thereof that Cameron J found that the consumer did not reinstate the agreement before the bank sold the property in execution he held that it was not necessary to consider the argument that the point of no return in the process of execution occurred before the alleged reinstatement of the credit agreement nor was it necessary to consider the meaning of the terms "attachment order", "court order", "sale" or "execution" in section 129(4). He further held that it was also not necessary to consider whether section 129(3) requires the consumer to communicate her intention to reinstate to the bank.[54]

Nugent AJ in a further separate judgment indicated that he agreed with Cameron J that the appeal must fail and the order of the Supreme Court of Appeal should be left undisturbed. His reasons for coming to this conclusion were as follows: he stated that it was a common feature of credit agreements that upon default the credit provider would become entitled to enforce the agreement and incur costs in doing so.[55] He indicated that section 129(3) indeed makes inroads upon the ordinary right of the bank to recover the loan upon default as the borrower may at any time interrupt the enforcement process and restore the earlier position upon fulfilment of the three conditions set out in section 129(3). He agreed that fulfillment of these conditions need not be communicated (by the consumer) to the bank.[56] He then stated: "[t]he section affords powerful protection to borrowers who fall into temporary distress (or carelessness) at any time until the loan is repaid. But it requires the borrower to comply with its conditions if she or he is to have that protection. The language in which the conditions have been expressed is straightforward, and I see nothing, in the context or its purpose, not to construe it for what it says."[57] Nugent AJ, however, distinguished the majority judgment as holding that the *costs* were not required to be paid because they were not due. He stated that the majority judgment construes the section as requiring payment by the borrower only if the

[53] par 67 to 68. He indicated (par 69) that s129(3) provides that the costs the consumer must pay must be "reasonable" and pointed out that it accords with the settlement agreement entered into by the parties on 10 December 2010 which *inter alia* required the consumer to pay the costs of the rescission application as "taxed or agreed". According to Cameron J, had she tendered payment of the bank's costs, the fact that they had not been agreed or taxed, as the settlement agreement required, or that there was no process through which it was established that they were "reasonable", as required by the Act, may have been in issue. However, because she made no tender this issue did not arise. He remarked (par 70): "Differently put, the fact that the costs had not been taxed or agreed did not absolve her from the obligation to pay them, or at least to tender payment of them, in order to reinstate the agreement. The Bank in argument readily conceded that it could not obstruct a consumer from reinstating a credit agreement that is in default by refusing to agree to what is reasonable. This is obvious. But the consumer must, at least, tender payment of what she considers to be reasonable."

[54] par 71 and 72.

[55] par 141.

[56] par 142 to 143.

[57] par 142 to 144.

bank has itself met certain conditions at the time the borrower seeks to invoke the section, namely that the borrower is required to pay the costs only if by then they have been taxed and demanded by the bank, absent which the borrower may reinstate the agreement by paying only the overdue amounts. However, according to Nugent AJ, the language of section 129(3) is against such a construction.[58] He indicated that the majority judgment does not suggest that demand by the bank is a pre-condition for payment of the overdue amounts and that he failed to see how it then becomes a pre-condition for payment of the costs when the same language is used for both. According to him such an interpretation is not supported by the context in which the section appears.[59] He also indicated that the purpose of section 129(3) is to throw a "lifeline" to a borrower that has defaulted and that it was not enacted to provide a remedy for banks to recover their costs.[60]

Nugent AJ agreed that the borrower is not required to notify the bank that he or she intends invoking the section, but pointed out that for this reason the bank will not know whether a borrower will invoke the section, and if it is invoked, when that will occur.[61] He further remarked that on the construction proposed by the majority, the bank would immediately need to tax and then demand its costs each time they are incurred, just in case the borrower were at some time to invoke the section, if it is to preserve its right to have them paid when reinstatement occurs, which approach Nugent AJ found unrealistic and not what section 129(3) means.[62] He further stated that whether costs are "reasonable as a fact" is not dependent upon the opinion of a costs assessor.[63] Nugent AJ indicated that demand might or might not be a prerequisite for a debt to become payable depending upon the particular facts. He pointed out that in the present case the consumer was obliged in terms of clause 11.1.3 of the agreement to "pay all costs including attorney and client costs and collection commission incurred by the Bank…in demanding or obtaining payment of all or any sums due by the [borrower]…to the Bank and in suing for the recovery thereof" without any precondition of demand. However, he indicated that he did not reach his conclusion on the basis of the agreement but on the basis that section 129(3) does not require payment of costs only if they have become payable at the time the section is invoked. The section itself

[58] par 145 to 147. He indicated: "In its terms it requires the borrower to pay. Nothing in the language of section 129(3) of the Act suggests that sometimes the borrower need not pay".

[59] par 148. He stated that perhaps greater transparency in bank billing is desirable but if so it is a matter for the legislature to correct. He indicated that Moseneke DCJ had pointed to nothing in the Act indicating that the legislature has chosen to achieve billing transparency through enacting s 129(3) nor did he find support for such a construction in the purpose of s 129(3).

[60] par 149. He remarked that "No doubt the Bank in this case would have been perfectly content to recover its costs in the ordinary way. To construe it as attaching conditions if banks want to recover their costs does not give effect to its purpose but inverts it instead."

[61] par 150.

[62] par 150 and 151.

[63] See the explanation for this statement in par 152. He stated that it, however, does not leave the bank at large to determine the extent of the costs as the section requires that the costs must be reasonable and the borrower is free to obtain the opinion of a taxing official and it would be a "naïve bank that sought to require payment of more than the amount considered by the taxing official to be reasonable". He remarked that even then the borrower is not required to pay the amount in which the costs have been taxed because s 129(3) does not require the borrower to pay what a taxing officer believes to be reasonable: the borrower is required to pay what is reasonable as a fact. Ultimately a court will have to determine whether the costs are reasonable should it be disputed in legal proceedings (par 154).

makes them payable as a condition for reinstatement if they have been incurred.[64] Nugent AJ further disagreed with the view of the majority that the borrower cannot be expected to take proactive steps to find out what the costs would be for reinstatement to be effected.[65]

Jaftha J agreed with the majority that the appeal should be upheld mainly for the reasons advanced by Moseneke DCJ but added thereto, in a separate judgment, his own reasons as well. He was of the view that the legal costs claimed were not due. He stated that the litigation instituted by the bank was irregular as it was commenced without compliance with section 129(1).[66]Accordingly no legal fees were due in this matter because the institution of the legal action without compliance with section 129(1) was irregular and the default judgment was a nullity because the registrar had no power to grant it.[67]

## 6 *Discussion*

As indicated above the focus of this discussion is the majority judgment, the current binding authority in respect of credit agreements that are alleged to have been re-instated in terms of section 129(3) and (4) prior to 13 March 2015, which is the date on which the amendments to section 129(3) and (4) in terms of the National Credit Amendment Act came into effect. As will be indicated below, this judgment, however, also impacts upon the interpretation of the amended versions of section 129(3) and (4).

The gist of the majority judgment can be summarized as follows:

(a) The NCA calls for a balanced approach regarding the rights and obligations of consumers and credit providers and aims at correcting and addressing previous imbalances in bargaining power between the parties.

(b) It acknowledged the statutory right of a consumer to reinstate a credit agreement as per section 129(3) read with section 129(4). It further acknowledged that this right to reinstatement is available to a consumer who is in default under a credit agreement (only) *before* cancellation of such credit agreement by the credit provider – this it did by effectively indicating that in the event of mortgaged property "foreclosure" entailed triggering an acceleration clause without cancelling the agreement. In this regard the court held that "[i]f the acceleration clause is resorted to while the contract subsists and the Bank demands full payment it is not the same thing as cancellation of the agreement for breach". However, it

[64] par 156. He stated that to construe "incurred" as meaning "then payable" does violence to the language of the section and remarked that there was no dispute that the costs in issue in this matter had indeed been incurred by the bank, provided that they were reasonable and there was no suggestion that they were not reasonable. Thus if Mrs Nkata wanted them taxed then it was for her to ask for it, and pay them once they were taxed – they could not simply be ignored.

[65] par 157. He indicated that he could imagine few borrowers having records that are so meticulous, and whose calculations of compound interest are so exact, as to be capable of knowing what is overdue without asking the bank. In his opinion it is not unduly oppressive to expect a borrower to ask at the same time what costs have been incurred. He remarked that it is the bank, instead, that cannot be expected to know whether, and if so, when, the borrower will invoke the provision, and so be obliged to tax and demand its costs in case that should occur. See further par 158 to 161 where Nugent J deals with the judgment of Jaftha J.

[66] The consumer alleged that she did not receive a s 129(1)(a) notice and from the facts of the matter it appeared that she was sent such a notice on more than one occasion but to incorrect addresses.

[67] par 163 to 189. As authority for this finding he referred to *City of Johannesburg v Changing Tides 74 (Pty) Ltd* (2012) ZASCA 116 and *Master of the High Court Northern Gauteng High Court, Pretoria v Motala NO* (2011) ZASCA 238. (Note, however, Nugent J's remark (par 161) that the *Motala* matter is not authority for the findings made by Jaftha J.)

also indicated that *in casu* the credit provider could only have lawfully terminated the credit agreement in terms of section 130 read with section 129 and that, because it had failed to comply with section 129, the agreement was therefore *not* cancelled.[68]

(c) The court further acknowledged that this right to reinstatement is exercised by the consumer upon making specified overdue payments, as stated in section 129(3). Upon the consumer making the specified overdue payments, the agreement is reinstated and the consumer may resume possession of the property that has been attached by the credit provider in terms of an attachment order. In order to reinstate the consumer must pay "all amounts that are overdue" which means only the arrear amounts and not the full accelerated debt. The court did not specifically deal with the concept of "permitted default charges".

(d) As regards the procedural aspects of this right, the majority confirmed that the agreement is reinstated by operation of law upon the specified payments being made – that is, the consumer is under no obligation first to give the credit provider notice of an intention to reinstate.

(e) However, because the arrear legal costs were not presented to the consumer, "inviting" her in a separate notice or demand, to pay, these costs were not due and payable. (Also the majority referred rather approvingly (although not reaching as firm a conclusion) to the fact that because the legal costs were debited against Mrs Nkata's account, the High Court inferred that the bank was happy to capitalize the legal costs, and, hence, that the consumer was not required to pay the legal costs, in addition to the arrears as indicated above, in order for the reinstatement of the credit agreement to become operative.)

(f) The majority, while not placing any positive obligation on the consumer to notify the credit provider of an intended reinstatement, however, deemed it fit to require the credit provider to take proactive steps if it wants to recover costs for enforcing an agreement with the consumer. This requirement is imposed because "the consumer could not be expected to take pro-active steps to find out what the costs would be for reinstatement to be effected". It appears that the majority also implied by the words "neither could a consumer be expected to start taxation or agree with the credit provider on the quantification of these costs" that where the consumer disputes the reasonableness of the legal costs, the credit provider is obliged to commence taxation proceedings if the parties are unable to agree on reasonableness of the costs.

(g) As regards the bar to reinstatement contained in section 129(4) the majority agreed with the High Court that this bar becomes operative when the proceeds from a sale in execution have been realized "because only then would revival be of no use to either party".

(h) The majority further held that section 129(3) amounts to "a statutory remedy for rendering a default judgment and an attachment order "ineffectual" and also that the effect of section 129(3) is to supersede the common law judicial mortgage.

The necessity of a right to reinstate a credit agreement in certain instances was indeed on the agenda of the legislature when the NCA was enacted, as is clear from the provisions of section 129(3) and (4). It is also not contended in this contribution that such a right should not be afforded to a consumer. However, it may be asked whether the circumstances under which such reinstatement can be exercised and the parameters of the right to reinstate a credit agreement, were correctly borne out by the provisions of section 129(3) read with section 129(4) in their original format, and whether the majority in *Nkata* was correct in their interpretation of the obligations of the parties in the context of reinstatement as well as the cut-off time after which reinstatement is no longer competent.

The court in *Nkata* (all the judges actually) appeared to agree that a consumer in the context of mortgage credit should be able to reinstate a credit agreement and avoid the subsequent loss of his or her immovable property through a sale

[68] It appears that the court uses the words "terminate" and "cancel" in the same sense.

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in execution. Consequently it is not strange that the majority, like the High Court, decided upon an interpretation of section 129(3) that "reconciled" the use of the words "reinstate" and "before cancelled" in that subsection. Although it can be doubted that the interpretation afforded by the court to the words "before cancelled" was in fact what the legislature had intended when it drafted the provision, the majority's interpretation that foreclosure does not amount to cancellation, is plausible.

As regards the operation of the right to reinstatement it is interesting to note that there is no indication of a balanced approach by the majority. There is also no indication that the unbalanced approach that they did in fact follow, namely to load the obligations of the credit provider but not of the consumer, was necessary to achieve some or other "past imbalance". It must be borne in mind that the clear wording of section 129(3) places no express obligation on either of the parties to give the other notice of any kind. The majority, however, deemed it fit to allow the consumer (who is the party seeking the "indulgence" of reinstatement) to reinstate the credit agreement without any prior notice but merely by paying the amounts mentioned in section 129(3). It further curtailed this obligation of the consumer to effect reinstatement by means of payment of certain amounts by requiring that the credit provider notify the consumer of the outstanding legal fees, which fees must be reasonable (as per section 129(3))[69] and indicating that in the absence of agreement between the parties on the reasonableness of the fees, the credit provider must see to the taxation thereof. If no such notification is done, then the consumer may reinstate the agreement without having to pay the legal fees – despite section 129(3) providing that the reasonable legal costs should be paid *before* a credit agreement is reinstated. Also, if the credit provider has in the meantime debited the legal fees to the consumer's account, then the majority (although it indicated that it was not necessary to reach as firm a conclusion on this point as the High Court) appears to consider there to be merit in the argument that these legal fees lose their separate character with the effect that they need not be paid in order for reinstatement of the (not cancelled) credit agreement to occur.

If one considers this obligation that the Constitutional Court imposes on the credit provider in more detail it appears that it has been imposed in a quite impractical setting: if the consumer is under no obligation to give the credit provider any advance notification of its intention to reinstate the credit agreement that is in default , how will the credit provider know *when* to notify the consumer of the arrear amounts, default charges and more specifically, reasonable legal costs of enforcing the agreement?[70] Or does the majority expect the credit provider to notify every consumer continuously of every arrear amount, default charge and amount of enforcement costs that is being incurred *just in case* a consumer may at some point wish to reinstate a credit agreement? This obligation that has been imposed on the credit provider is not only onerous but the fact that the majority failed to consider the practicality of imposing such an obligation absent a balancing obligation on the consumer to give notice of his intention to reinstate a credit agreement, makes it difficult to conceive exactly what a credit provider must do in order to comply with this obligation.

Further it appears that this obligation is actually two-fold in nature: the credit provider must give notice of the reasonable legal costs of enforcing the credit

[69] See Brits (n 9) regarding what would constitute reasonable legal costs for purposes of s 129(3).
[70] This problem has also been pointed out by Nugent AJ in his minority judgment (par 150).

agreement and then, if such costs are disputed and cannot be agreed upon between the parties the credit provider must attend to taxation thereof – yet another onerous and time-consuming obligation that delays the point at which reinstatement can occur. Or even worse, if the credit provider really wants to pre-empt any problems he must, as suggested by Nugent AJ,[71] tax the cost every time before "inviting" the consumer to pay it. Here of course one must also pause to ponder on the appropriateness of the majority's use of the word "invite" which is hardly a word that one would use in the context of demanding payment from a person who has breached a credit agreement.

It appears that the majority has selectively put words into the mouth of the legislature by reading into section 129(3) a notification obligation for the credit provider regarding legal costs and also by finding that if such notice is not provided reinstatement can occur absent payment of legal costs (even though the clear wording of section 129(3) requires payment of legal costs *in order for* reinstatement to become operative). At this point one can ask why a credit provider should not also in the notice that the majority requires him to give, reflect the arrear amounts and permitted default charges?[72] And, given that the arrears and permitted default charges will also be debited to the consumer's account as they arise, does the High Court's argument regarding "loss of separate character" (that the majority apparently quite liked but was not prepared to actively endorse) then not also apply to them so that one can argue that the consumer also need not pay these costs because they were already debited against the account? Further, it can be questioned whether the approach of the majority (in agreeing with the High Court that initially voiced these sentiments) that "the consumer cannot be expected to take pro-active steps to find out what the costs would be for reinstatement to be effected" is correct? Surely a consumer, who is in breach of a credit agreement and seeking the indulgence of having the credit agreement reinstated because of his failure to make the payments stipulated in the agreement, can pick up a phone or write a letter or an email or attend at the offices of the credit provider to find out what the amounts of legal costs are that he must pay? One can maybe understand the court's sentiment that generally consumers would not know how to start taxation given that it entails a specific court procedure, but to hold that consumers cannot be expected to take pro-active steps to find out what the costs would be for reinstatement to be effected, shows that the court wanted to bend over backwards to accommodate the consumer even at the expense of common sense and the balance that the NCA aims to achieve.

As regards the majority's agreement with the High Court that the default judgment and writ of execution ceased to have any force or effect as from the date of reinstatement, 8 March 2011, which act of reinstatement occurred after default judgment had already been granted against the consumer, one can also ask a few questions. What exactly does it practically mean? The problem is that the whole debacle about reinstatement may have helped Mrs Nkata to get her house back but she still has a judgment against her name. The stage at which reinstatement occurred should surely also have some effect: if reinstatement occurred prior to the granting of a default judgment then one can argue that the judgment was never competent and that the bank should apply to have it set aside or at least agree to a rescission application on request of the consumer (for which costs the bank will then generally be liable) but if reinstatement occurred after default judgment does the majority judgment imply that such a judgment becomes non-existent or does it still have to

[71] par 151.
[72] This issue was also raised by Nugent AJ (par 148).

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be set aside (at the expense of the consumer) even though it has no force or effect because it is otherwise still going to impair the consumer's credit record?

The view of the majority that the cut-off point for reinstatement of a mortgage agreement in accordance with section 129(4) is when the proceeds of a sale in execution is realised, apart from difficulties that one may otherwise have with this narrow interpretation of "execution", is also not without problems as it can be asked exactly when such "realization of proceeds" occurs? Is it for instance when the purchaser's bid is accepted or is it when he gives a guarantee for payment of the purchase price or when the money is physically paid into the sheriff's account? It can also be questioned how appropriate this late cut-off interpretation is, having regard to its ability to erode legal certainty and prejudice third parties who buy property at a sale in execution.

The principle that should be borne in mind is that although reinstatement is a right it also is an indulgence shown towards a defaulting consumer. Suppose a consumer falls into arrears with his payments in respect of a mortgage agreement. Before foreclosing on the mortgage agreement, the credit provider is obliged to send the consumer a (pre-enforcement) section 129(1)(a) notice drawing his attention to his default and proposing that the matter be referred to a debt counsellor, ombud with jurisdiction, consumer court or alternative dispute resolution agent with the intent to resolve a dispute or to agree on a plan to bring the payments in terms of the agreements up to date.[73] If the consumer pays the arrear amounts specified in the section 129(1)(a) notice, the default is purged and the issue of reinstatement of a credit agreement does not arise. So, the implication is that the consumer who is eligible for reinstatement is a consumer who, despite having received a section 129(1)(a) notice and the opportunity to pay up the arrears and avoid enforcement and enforcement costs, did *not* remedy his default. Despite his breach, he is however afforded (statutorily) yet another opportunity to carry on with the contract – this is by virtue of section 129(3) which allows for reinstatement *before* cancellation. However, it should be noted that although the majority stated that foreclosure and the reliance on an acceleration clause is not the same as cancellation it also remarked in the same paragraph that because there was non-compliance with section 129(1)(a) in the *Nkata* case there was no cancellation.[74] This is quite confusing but what the court probably meant was that in order for cancellation to have occurred there should have been compliance with the provisions of section 129 as well as the relevant provisions of section 130 – and that although there may have been compliance with the provisions of section 130, the lack of proper compliance with section 129 meant that there was no proper cancellation – and that *in casu* there thus was no bar (being cancellation) to reinstatement of the credit agreement. So one would then probably be justified in concluding that the court was of the opinion that once a notice in terms of section 129(1) (a) was sent together with compliance with the relevant provisions of section 130, that combination of events would constitute cancellation of the credit agreement or that it would at that stage put the credit provider in a position where he would then be entitled to cancel the credit agreement. If this is in fact what the court meant then it implies that the consumer would be able to invoke the right to reinstatement at this stage before the credit provider communicates his intention to cancel the credit agreement.

[73] S 129(1)(b) of the NCA requires delivery of a s 129(1)(a) notice before the credit provider may proceed to enforce that agreement by litigation.

[74] See also the High Court judgment par 40.

Although one can argue about the interpretation of the original section 129(3) and (4) for months, it will not really matter at this stage, as the Constitutional Court has pronounced on it and it is that legal position that will prevail until, if ever, it is overturned or tweaked by the Constitutional Court itself or until the legislature comes up with further amendments to section 129(3) and (4) other than the amendments effected by the National Credit Amendment Act as discussed below. It must also be remembered that the *Nkata*-judgment dealt specifically with a mortgage agreement and did not address the issue whether reinstatement is competent with regards to agreements where movables are concerned, even though the use of the word ”property” in section 129(3) is wide enough to encompass immovables and movables. Practically in the context of mortgage agreements, the Constitutional Court has held that reinstatement in terms of section 129(3) and (4) is only competent where the credit agreement has not yet been cancelled and it has indicated that the general process of foreclosure of a mortgage agreement, namely where an acceleration clause is invoked, does not amount to cancellation with the effect that in the event of foreclosure the consumer can reinstate until a very late stage, being until the proceeds of a sale in execution are realised (but before transfer of the property). Thus, in practice credit providers in respect of movables will generally be able to act quickly to prevent consumers from reinstating credit agreements, especially if they cancel the agreement soon after the section 129(1)(a) notice has been sent and the time periods in section 129(1) read with section 130(1) have expired. Accordingly, even if a consumer in respect of a credit agreement in terms of which, for instance, a car was sold or leased can be said also to be entitled to reinstatement of the credit agreement upon payments of the amounts specified in section 129(3), he will generally have a very limited to exercise this right, especially if he credit provider is vigilant in cancelling the credit agreement and enforcing same. However, the consumer under a mortgage agreement, such as Mrs Nkata, has been afforded a very long period by the majority during which the agreement can be reinstated. Thus, where immovable property is at stake, consumers are actually very well protected and afforded various opportunities to prevent parting with their immovable property, especially if such immovable property is their primary residence, which it often is. Such protection entails *inter alia* that once in default, the consumer will be afforded an opportunity to remedy the default pursuant to a section 129(1)(a) notice. Once the default is purged, the credit agreement continues as normal and no enforcement ensues. There is no limitation on the amount of times that a section 129(1)(a) notice should be sent to a consumer – and as it has to be sent every time the consumer is in default it is clear that over the lifetime of a particular credit agreement the consumer can use the section 129(1)(a) notice on various occasions to remedy his default and continue with the agreement.[75] If the consumer fails to remedy his default upon receiving a section 129(1)(a)-notice and the credit provider proceeds to enforce the agreement the specific method of enforcement, namely “foreclosure”, will not amount to “cancellation” of the agreement thus preserving the consumer’s opportunity to reinstate the agreement until, apparently, the cut-off point stated in section 129(4)(b), namely “execution of any other court order enforcing that agreement.” There is no cap on the amount of times that a consumer may reinstate a credit agreement as long as the cut-off point in section 129(4)(b) is not reached at any stage prior to

[75] of course, the more s 129(1)(a) notices sent, the more the default charges that will be debited against the consumer’s account.

such purported reinstatement – so the consumer may possibly even avail himself of the right to reinstatement a few times during the course of a mortgage agreement – very much like Mrs Nkata. It should also be remembered that section 26 of the Constitution provides for a right of security of tenure[76] with the effect that a court will, in accordance with its judicial oversight mandate occasioned by section 26, in the event that the mortgaged immovable property is the primary residence of the consumer, still have a discretion whether to order execution against such property or not.[77] It should further be noted that the courts have held that the consumer should be alerted to his right in terms of section 26 in the Constitution at various stages, *inter alia* in the section 129(1)(a)-notice (Gauteng), and in the summons that is issued to enforce the credit agreement.[78]

Currently it thus seems that, from a credit provider's perspective, the issue of reinstatement in the context of movable property is not really that big a headache in any event. If the matter relates to a credit agreement where reliance is placed on the original section 129(3) and (4) for purposes of reinstatement, all that has to be established is whether the agreement was cancelled by the time the consumer sought to reinstate the agreement. It appears that if by that time the credit provider had duly complied with section 129 read with section 130 and cancelled the agreement, reinstatement can no longer occur by virtue of section 129(3). It is then not necessary even to consider the provisions of section 129(4). Of course, if there is something wrong with the section 129(1)(a) notice such as that it was delivered at the incorrect address and the consumer in the meantime unilaterally (as he is entitled to do in accordance with case law) pays the amounts mentioned in section 129(3) it may be possible for reinstatement to occur as the agreement can then not be held to have been duly cancelled prior to such "reinstating" payments by the consumer.

However, the *Nkata*-judgment has made the issue of reinstatement much more of a headache for providers of mortgage credit, which agreements generally span over four to five times the lifetime of credit agreements such as instalment agreements and leases where the security is movable in nature. *Nkata* in essence conjures up the image of a "long and winding road" for the mortgage credit provider: long, because mortgage agreements span over many years and "winding" because *Nkata* has created a fluid and uncertain "wind" in the road for credit providers, a "bend" around which it is not always possible to see.

What can a mortgage credit provider now, after the *Nkata*–judgment do regarding a possible reinstatement that might have occurred in accordance with the original section 129(3) and (4)? Precious little other than to wait it seems. Reinstatement is an issue to be invoked by a consumer if that consumer has in fact paid the amounts stipulated by section 129(3) at a time before the agreement was cancelled. Surely it cannot mean that credit providers must now in a frenzy go and "exhume" all credit agreements that were in default at a previous stage and where the credit provider subsequently foreclosed on the mortgage agreement and sold and transferred the immovable property to see whether, possibly, some of these

[76] S 26(1) provides that everyone has the right to adequate housing whereas s 26(3) provides that no one may be evicted from their home, or have their home demolished, without an order of court made after considering all the relevant circumstances and that no legislation may permit arbitrary evictions.

[77] *Gundwana v Steko Development CC* 2011 3 SA 608 (CC).

[78] *Firstrand Bank Ltd v Folscher* 2011 4 SA 314.

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agreements were actually reinstated at some time prior to the realization of the proceeds of the sale. All that can be done now in such instances is to deal with the "ghosts" of reinstatement if and when they appear and then to make an appraisal of the particular facts at hand to see whether the allegation that reinstatement occurred is correct or not. This appraisal will then entail applying the judgment of the majority to determine whether the amounts that should have been paid were paid and also to determine whether these payments occurred before the cut-off time approved by the Constitutional court. Where the facts are similar to *Nkata* in the sense that the credit provider merely debited the legal costs to the consumer's account instead of providing the consumer with a notice "inviting" him to pay the reasonable legal costs, the mere payment of the arrears and permitted default charges will be sufficient to constitute reinstatement as long as this payment has occurred prior to the realization of the proceeds of the sale. Because section 129(3) does not expressly require that the credit provider notify the consumer of the reasonable legal costs it is doubtful whether mortgage credit providers would have had the foresight, prior to the *Nkata*-judgment, to realize that they should have complied with this obligation which the Constitutional Court somehow read into section 129(3), and it is submitted that in most of those cases they would have debited the legal costs against the consumer's account and not have sent a separate notice inviting payment thereof, hence making it possible for those consumers who only paid arrears and permitted default charges at a specific point in time prior to cancellation of the agreement, to claim that their agreements have been reinstated.

Of course it would even be possible for credit providers who commenced foreclosure on mortgage agreements prior to 13 March 2015 but where the litigation has not been concluded and the property not yet sold, if they desire to mitigate the problems occasioned by a possible reinstatement that may have occurred at an earlier stage, to scrutinize the mortgage account for traces of payments that could amount to reinstatement and so to save themselves from engaging in protracted litigation only to hear at the end of it that it was all in vain and at their expense. However it is doubtful that the legislature ever intended that such "hurrying and scurrying" by a credit provider should result from a statutory indulgence to a defaulting consumer to retain possession of his property.

## 7 *The impact of Nkata on section 129(3) and (4) as amended*

The National Credit Amendment Act amended section 129(3) and (4) with effect from 13 March 2015 so that it now reads as follows:

> "(3) Subject to subsection (4), a consumer may at any time before the credit provider has cancelled the agreement, remedy a default in such credit agreement by paying to the credit provider all amounts that are overdue, together with the credit provider's prescribed default administration charges and reasonable costs of enforcing the agreement up to the time the default was remedied."
>
> "(4) A credit provider may not re-instate or revive a credit agreement after –
> (a) the sale of any property pursuant to –
> (i) an attachment order; or
> (ii) surrender of property in terms of section 127;
> (b) the execution of any other court order enforcing that agreement; or
> (c) the termination thereof in accordance with section 123."

The amendments to section 129(3) and (4) unfortunately dismally failed their purpose – instead of producing clarity the amendments have created even more

confusion than the original section 129(3) and (4). Section 129(3) no longer refers to "reinstatement" but to "remedying a default" before cancellation – and instead of a subsection (a) and (b) the provision now does not contain any reference to return of goods that have been repossessed in terms of a court order (although one might argue that the implication is that upon remedying the default property that may have been attached, if any, will have to be returned). For some inconceivable reason section 129(4) has been amended to provide that a "credit provider" (not a "consumer" as per the original section 129(4)) may now not "reinstate or revive" a credit agreement after the cut-off dates in section 129(4)(a) to (c) – which cut-off dates have not been amended and are the same as in the original section 129(4)(a) to (c). Given that section 129(3) now provides for the consumer to "remedy a default" whereas section 129(4) refers to "reinstate or revive" there is a disconnect between these two subsections and the only indication that they actually have something to do with each other is the fact that the amended version of section 129(3) still provides that the consumer can exercise the "right" mentioned therein subject to subsection 4. One can speculate extensively about what went on in the mind of the legislature when it drafted the amendments to section 129(3) and (4): probably it decided to use the words "remedy a default" rather than "reinstate" because of the rap it got for previously using "reinstate" in a context where it appeared to be in conflict with the requirement that it had to occur *before* cancellation of the agreement. Presumably it got rid of the reference to "attachment" of property by a court order as the concept was problematic in the context of immovable property. Why it substituted "consumer" with "credit provider" in section 129(4) is a riddle. The answer to what exactly was going on in the legislature's mind when it effected these amendments is probably even unclear to the legislature itself.

The amendments to section 129(3) and (4) have been criticised by authors as vague and in need of reform.[79] Thus the jury is out but the problem still remains that these amendments are the current state of the law on reinstatement of credit agreements and provide the parameters within which courts will have to establish whether a credit agreement that is alleged to have been reinstated subsequent to 13 March 2015 has in fact been reinstated. At this stage possible further amendments to section 129(3) and (4) to clear up the mess is music for the future and it is submitted that in the interim courts are likely to interpret section 129(3) as still in essence providing for reinstatement of a credit agreement (especially given that it is still subject to section 129(4) which still uses the word "reinstate").Whether the use of the word "credit provider" in section 129(4) will make any difference at all is debatable as any reasonable person would agree that neither a consumer nor a credit provider should be able to reinstate a credit agreement after those cut–off points listed in section 129(4).

So how does the Constitutional Court's judgment in *Nkata* impact on the amended section 129(3) and (4)? Cancellation will still constitute a bar to the remedy in section 129(3), thus in the context of mortgage credit. The Constitutional Court's argument that foreclosure by invoking an acceleration clause will still apply in order to justify the mortgage consumer being able to use this remedy despite the foreclosure of the agreement. As the amounts that have to be paid in order to "remedy a default" have not been changed when the subsection was amended, and as no specific notification requirements have been inserted into the amended

[79] Brits "The 'reinstatement' of credit agreements: remarks in response to the 2014 amendment of section 129(3)-(4) of the National Credit Act" (2015) 48 *De Jure* 75-91.

subsection, courts will be bound by the majority judgment in this respect: thus the remedying of a default (aka reinstatement) can still occur by operation of law and without any prior notification to the credit provider while the credit provider will have to provide the consumer with notice of the amounts that must be paid; and if the reasonableness of the enforcement costs is disputed the credit provider will have to see to taxation thereof. As indicated above, the practicalities of these obligations that have been imposed on the credit provider were not considered by the majority, so how and when exactly the credit provider must attend to these obligations is unclear.

Accordingly, in the meantime, given that this is the sorry state of affairs under which credit providers have to conduct their business, what can a credit provider, especially a mortgage credit provider, do to mitigate its risks of being caught with its pants down? Can it for instance insert a provision in its credit agreements requiring consumers to give advance notice of their intention to "reinstate" a credit agreement and indicating that upon receipt of such notice the credit provider will provide the consumer with the detail of the specific amounts that have to be paid in respect of arrears, permitted default charges and legal costs of enforcing the agreement up to the time of reinstatement? Will such a clause not be regarded as being in conflict with the majority in *Nkata's* finding that the consumer has no obligations to give notice of his intent to reinstate? Can the credit provider in the section 129(1)(a) notice inform the consumer that if he fails to bring his payments up to date he still has some opportunity to reinstate the agreement in accordance with section 129(3) before the credit provider cancels the agreement? Obviously such a notification will have limited application except in the case of mortgages where the credit provider forecloses. And in the event of foreclosure of a mortgage agreement, must the summons mention anything about section 129(3) and that, in terms of the agreement, the consumer must give notice of its intention to reinstate? Clearly if a notice is provided to the consumer regarding costs that have to be paid it would be prudent not to deal only with the legal costs but also to set out the arrears that have to be paid as well as the permitted default charges, and also to indicate to the consumer that he must indicate within a specified number of days whether he agrees that the legal costs are reasonable or not so that the credit provider can proceed with taxation thereof.

## 8 *Conclusion*

The majority judgment in *Nkata* has indeed "skewed the balance" that the NCA seeks to achieve between the rights and responsibilities of the consumer and credit provider unfairly in the favour of the consumer. There can be little doubt that the majority judgment is wrong insofar as it has forsaken the balanced approach of the NCA to impose onerous burdens relating to notification and taxation of legal costs on credit providers whilst giving no consideration to the fact that reinstatement attempts to assist a consumer who is in breach of a credit agreement to escape the ill-effects of such breach by forcing a credit provider to carry on with the agreement if the consumer makes certain payments. The reinstatement landscape within which credit providers now have to find their way is fraught with additional onerous compliance layers smothered in uncertainty. It is in this uncertain landscape, and with the hope of better legal reform in future or at least a "toning-down" of the unfairness of the majority judgment in *Nkata,* that credit providers will now have to navigate their way towards practical solutions to deal with the compliance burden that has undeservedly been dumped on them.

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