Annual Banking Law Update 2017

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Recent Legal Developments of
Special Interest to Banks

Editors: **Charl Hugo & Sarel du Toit**

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First published 2017

Juta and Company (Pty) Ltd
First Floor
Sunclare Building
21 Dreyer Street
Claremont
7708

www.jutalaw.co.za

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ISBN: 978 1 48512 608 9

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Production Co-ordinator: Valencia Wyngaard
Typesetter: Elinye Ithuba dtp solutions
Cover Design: Matthew Bubear-Craemer
Printed by:

Typeset in 10pt on 12pt Times New Roman

Preface

It is generally acknowledged that "banking law" is notoriously difficult to define satisfactorily. Despite this truism we believe that most of you will agree that the past year has probably been one of the most important for a long time for lawyers who are interested in banking. The Financial Intelligence Centre Amendment Act was enacted (implementing changes required in the recommendations of the Financial Action Task Force); so, too, was the Financial Sector Regulation Act (implementing the so-called "Twin Peaks" regulation model). The unilateral closure of bank accounts has been especially prominent in the news, especially in relation to the accounts of Gupta-owned companies. Trade digitisation and blockchain technology have become very prominent themes of late – prompting, inter alia, the important question regarding the nature of (the business of) the future bank. Developments in the law of companies, credit transactions, insurance, tax and guarantees remain important for banking lawyers. Against this background we are happy to be able to say that all of the above developments feature to some degree in the *Annual Banking Law Update* of this year.

As in 2016, the *Annual Banking Law Update (ABLU) 2017* consists of the *ABLU Book* (which is again the fruit of collaboration between the Centre for Banking Law of the University of Johannesburg and Juta and Company (Pty) Ltd) and the *ABLU Conference* (which, this year, is held at, and sponsored generously by, ENSAfrica in Sandton).

Those authors who have contributed essays to the *ABLU Book* hail from three countries (South Africa, the United States and Australia); some are academics (representing three universities); some are banking lawyers from three of our commercial banks; and one is from a research institute in the United States (the Institute of International Banking Law and Practice). We are overwhelmed by the positive response that we almost invariably receive from the persons that we approach to contribute to ABLU. To all of you we wish to convey our sincere gratitude and appreciation for your work. The quality and topical nature of the presentations, papers and essays over many years have made this event what it is today – in our view one of the best annual conferences relating to any aspect of commercial law in South Africa.

The ABLU model, of course, has long been that the essays of the *ABLU Book* are introduced by the authors at the *ABLU Conference*. Unfortunately, this year, two of the authors (Dr Herbert Kawadza of the University of the Witwatersrand, and Dr Karl Marxen of the Institute of International Banking Law and Practice in the United States) are unable to introduce their essays on the conference day. The editors wish to express their great appreciation and gratitude to both Dr Kawadza and Dr Marxen for producing their respective essays for the *ABLU Book* despite not being able to attend the conference. Dr Kawadza's essay deals with the important topic of financial inclusion (the problem of the so-called "unbanked") and Dr Marxen's provides a comprehensive overview of international case law relating to demand guarantees and standby letters of credit.

Our sincere thanks also to Juta & Co, and, especially, Linda van de Vijver, who has willingly and professionally assisted us throughout the project.

The personal pronoun employed repeatedly above is absolutely not a *pluralis majestatis*. Our ranks have swelled. There are now two editors. Nevertheless, the severe time constraints relating to the production of a publication of this nature have necessitated a rather robust editing approach. As a consequence, mistakes in the text may well be the fault of the particular editor, and not of the author concerned. As to who edited what, we choose to remain mum!

We conclude by expressing the hope (with some confidence) that the *ABLU Book* (2017) will contribute to a better understanding of banking law in South Africa and will stimulate research in this important field.

Charl Hugo and Sarel du Toit
Editors
Centre for Banking Law
University of Johannesburg

9 October 2017

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Change as the only constant: The future bank and implications for regulation

NATANIA LOCKE*

1 *Introduction*

It seems that the rise of financial technology ("fintech") is on everyone's lips these days. This year alone the Financial Stability Board ("FSB"), the Basel Committee on Banking Supervision ("BCBS") of the Bank of International Settlements ("BIS") and the International Organization of Securities Commissions ("IOSCO") have published reports on the possible implications of fintech on the banking industry and how this might impact on regulation and systemic risk.[1] Their reports have relied extensively on the continuous work that the large consulting firms are doing in this area as well as on direct feedback provided by their members.[2]

Fintech has been defined as "technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services."[3]

Technology has always had an impact on banking activity. The bank of today already looks vastly different to the bank of thirty years ago. The advent of automatic teller machines ("ATMs") have drastically reduced the need for an extensive physical branch system, thereby reducing costs. Electronic funds transfer ("EFT") has almost removed the use of cheques for payments by retail customers. Additionally, EFT has made the process of payment mostly more secure and much faster than would have been the case using cheques. The use of

* Visiting Professor, University of Johannesburg.
This is a working paper. The author welcomes your comments and suggestions at natania.locke@gmail.com.

1 Financial Stability Board *Financial Stability Implications from Fintech: Supervisory and Regulatory Issues that Merit Authorities' Attention* (2017); Basel Committee on Banking Supervision *Sound Practices: Implications of Fintech Developments for Banks and Bank Supervisors* (2017); International Organization of Securities Commissions *IOSCO Research Report on Financial Technologies (Fintech)* (2017). See further World Economic Forum *Beyond Fintech: A Pragmatic Assessment of Disruptive Potential in Financial Services* (2017) and He, Leckow, Haksar, Mancini-Griffoli, Jenkinson, Kashima, Khiaonarong, Rochon and Tourp *IMF Staff Discussion Note Fintech and Financial Services: Initial Considerations* (2017).

2 McKinsey & Company *Cutting through the Fintech Noise: Markers of Success, Imperatives for Banks* (2015); Accenture *The Future of Fintech and Banking: Digitally Disrupted or Reimagined?* (2015); Capgemini and LinkedIn collaborating with Efma *World Fintech Report 2017* (2017). Deloitte collaborated in the World Economic Forum Report (n 1) and KPMG International has recently acquired a Matchi, a platform that matches financial institutions for collaboration (see https://www.accountantsdaily.com.au/mergers-and-acquisitions/10218-big-4-firm-announces-global-acquisition (10-09-2017)).

3 FSB (n 1) 7.

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credit cards has drastically reduced the use of cash and is facilitating cross-border payment without the need to change currency at the airport or at the branch. These technologies are now well-settled in the banking industry, but there must have been a time when their introduction caused concern and uncertainty.[4]

Today we stand at the advent of a myriad of technologies that seem to stand on the horizon of potentially substantially changing the banking industry. It seems that this change may be exponentially larger than that previously created by technology, but only time will tell how quickly, to what extent, and in which forms these changes will manifest in the financial system.[5] These technologies hold the potential to reduce consumer cost and to enhance the consumer experience. At the same time, they could expose the consumer and the financial system as a whole to additional risk. It seems that everyone is at least agreed that regulation must find a balance between fostering innovation in favour of the benefit of the consumer, while maintaining consumer protection and systemic risk monitoring functions.[6] Inflexible, hard-line regulation could set barriers to entry that would see less competition in the market. Less competition would see a greater concentration of financial services in the hands of a few very large players, adding to systemic risk. On the other hand, overly lenient regulation could see wide-scale consumer detriment and failure risk, which poses systemic risk of its own. Herein then lies the dilemma for regulation.

This paper considers the findings of the FSB, BCBS, and to a lesser extent IOSCO, regarding the implications of fintech for the banking industry. It then critically considers the current methods that regulators are using to foster and monitor financial innovation, with a view of making recommendations in the South African setting.

It falls beyond the scope of this paper to consider individual technologies, or to predict precisely the impact that such technologies will have on specific sectors of the financial industry. It is assumed here that at least some of them will have a significant impact.[7]

2 *The future bank – possible scenarios*

It seems that there is consensus that large established technology companies will have a future role to play in financial service delivery. Some term this "the

[4] See also FSB (n 1) 10 for a similar view.

[5] McKinsey (n 2) 5 predicts that 10 – 40% of retail bank revenues could be at risk from fintech by 2025, especially in the fields of consumer finance, mortgages, lending to small and medium sized enterprises, retail payments and wealth management. The FSB (n 1) 7 points out that the existing degree of competition in the financial services industry of a particular jurisdiction, as well as scale, efficiency and entrenchment of those providers may influence the extent to which fintech poses a risk to current banks. They seem to suggest that the risk may be greater for emerging economies where a larger number of "unbanked" consumers may gain access through mobile solutions.

[6] Pan "Structural reform of financial regulation" 2011 *Transnational Law and Contemporary Problems* 796 812 in fact considers this the challenge of all financial regulation.

[7] The technology most often mentioned in the cited reports are cloud computing, big data, artificial intelligence ("AI"), distributed ledger technology ("DLT" or "blockchain"), biometry and robo-advisors.

battle for customer relationship and customer data".[8] The so-called "Bigtech" firms already have access to a large global customer base and have technical ability that often outmatches that of incumbent banks.[9] It is acknowledged that cooperation between them and large incumbent financial institutions may pose some systemic risk owing to the potential scale of their reach.[10]

The BCBS report identifies five future scenarios within which the impact of fintech on the current banking institutions may manifest.[11] These scenarios can, and probably will, overlap.

In the first scenario, coined "the better bank", the current banks maintain their hold on customer relationships, but enhance their service delivery and business models through the use of innovative technology.[12] This implies that they add onto their legacy systems instead of building new technology platforms.[13] Banks currently hold significant customer trust, but it remains to be seen whether a generation of "digital natives" would set as high a premium on these trusted relationships, when they could get a better deal elsewhere.[14]

In the second scenario the current banks cannot survive the advent of banks built on an entirely new technological platform such as fintech companies or Bigtech companies with banking-licenses starting their own banks from scratch.[15] These new banks take over customer relationships previously owned by the current banks. It is theorised that such banks could entirely move away from branch-centred focus, which would in itself lower costs. It would also not be hampered by the organisational complexity of current banks.

In the third scenario a fragmentation of the financial services market occurs.[16] Customer relationships diverge amongst a large number of financial services providers who do not endeavour to provide a complete suite of services, but rather focus on a particular sector of the market. Current banks compete with these new suppliers to retain some core relationships and may elect to collaborate with some of them to this end.[17] Bigtech does the same. Some examples of this scenario already exist, for instance, where peer-to-peer lenders collaborate with established banks and where innovative payment systems like third party mobile wallets are used by established banks.

Another scenario is that banks give up the fight and decide to leave the front-end customer relationships to Bigtech and fintech companies, opting rather to

8 BCBS (n 1) 14.
9 Examples include Amazon, Google, Apple and Facebook in the West and Baidu, Alibaba and Tencent in the East (China).
10 BCBS (n 1) 15.
11 BCBS (n 1) 16-21.
12 BCSB (n 1) 16-17.
13 The FSB (n 1) 22 warns that the operational risk of maintaining legacy systems might sometimes be greater than that posed by implementing completely new systems.
14 See McKinsey (n 2) 3-4. It must also be mentioned that continual scandals in which banks are involved might exacerbate distrust in a larger group than only digital natives.
15 BCBS (n 1) 17-18.
16 BCBS (n 1) 18-19; McKinsey (n 2) 6-7.
17 It seems that the FSB (n 1) 21-22 foresees that decentralisation might not be as severe as some are predicting. Instead, they consider it likely that economies of scale and network effects will lead to a consolidation of providers, which may include incumbent banks.

focus on their core functions for which they have banking licenses – deposit-taking, lending and so forth – as service providers to the Bigtech and fintech companies.[18]

At the front-end companies make increasing use of data aggregators[19] to enhance the customer experience – a practice that customers become used to.[20] While this scenario seems unlikely at first glance, the BCBS report points towards instances where banks already undertake this type of secondary role.[21]

In the last scenario banks become completely irrelevant as disintermediation takes its full course.[22] Consumers deal directly with fintech providers, which provide a direct matching of consumers, depending on their needs. The most notable current example of this lies in peer-to-peer lending, where lenders are brought into direct contact with consumer borrowers through an online platform.

It is not possible at this point to predict which of the above scenarios will manifest most, but it is clear that some of them are already relevant and that all of them will most likely apply to some extent in the future. It is further clear that these changes are being taken seriously by supervisory authorities and that there should be a continuous re-evaluation of the resilience and efficiency of current regulation when it comes to fintech.

3 *Implications for supervisory authorities*

The first implication of the possible scenarios set out above is that there will have to be strong cooperation between domestic supervisors and regulators to make sure that areas that fall outside banking supervision or financial-conduct supervision are also monitored.[23] Of specific concern are aspects of data and privacy protection, consumer protection and, depending on where the supervision of this function lies within a particular country's regulatory framework, the monitoring of anti-money laundering and countering of terrorism provisions.

This cooperation will further need to extend to global cooperation between banking supervisors.[24] Facilitation of international cooperation for financial supervision is already well-established through mechanisms like the BIS, FSB

[18] BCBS (n 1) 19-20.

[19] "Data aggregation is a type of data and information mining process where data is searched, gathered and presented in a report-based, summarized format to achieve specific business objectives or processes and/or conduct human analysis" https://www.techopedia.com/definition/14647/data-aggregation (11-09-2017). Data aggregation is typically sourced from the internet and may be used to reduce big data into a manageable outcome. See Rubinfield and Gal "Access barriers to big data" 2017 *Arizona LR* 339; Helveston "Consumer protection in the age of big data" 2016 *Washington University LR* 859; Hirschey "Pragmatic acceptance of data scraping" 2014 *Berkeley Technology LJ* 897.

[20] See also McKinsey (n 2) 6.

[21] See for instance, WeBank, a licensed banking platform of WeChat, the first private commercial bank in China and owned by Tencent. WeBank offers the services and products of third parties, including existing banks, to its customers. See BCBS (n 1) 20. WeBank's website is www.webank.com, but it only contains content in Mandarin.

[22] BCBS (n 1) 20-21.

[23] BCBS (n 1) 33; FSB (n 1) 12.

[24] BCBS (n 1) 33; FSB (n 1) 1-2.

and IOSCO and has been exacerbated by the global financial crisis. The recent work done by these institutions shows that they intend to take a leading role in this area going forward. The FSB recommends immediate international cooperation between regulatory authorities in three areas, namely managing operational risks from third party services providers, mitigating cyber-risk and monitoring macro-financial risk.[25] However, while fintech does not operate extensively on a global scale at present, their potential for global reach means that international cooperation between regulatory agencies may prove to be essential in future.[26]

The BCBS recommends that banking supervisors should keep the need to be tech savvy in mind during their recruitment of staff in order to enable efficient monitoring and response to technological developments that may come.[27] It is further important that staff be trained to deal with technological advancement that might be relevant to their effective functioning. Report back from members shows that these practices are already to some extent visible in supervisory authorities.[28] However, the disparity in remuneration between those working for regulators or supervisors and those working in the private sector may pose long-term difficulties in this endeavour.[29] It is a ubiquitous problem that state agencies function under budgetary constraints, which hamper their ability to recruit competitively. This disparity holds the added consequence that the brightest minds end up in the private sector, meaning that the comprehension of technically difficult information becomes an obstacle for supervisors.[30]

Finally, advancement of technology may hold benefits of more efficient supervision for supervisory authorities.[31] A distinction is made between supervisory technology (suptech) and regulatory technology (regtech). Suptech is defined by the BCBS as "the use of technologically enabled innovation by supervisory authorities".[32] Regtech is "any range of fintech applications for regulatory reporting and compliance purposes by regulated financial institutions".[33] Sometimes the firms that offer such solutions are also referred to as "regtech". The essential difference is that suptech is implemented by supervisory authorities to enable and improve their supervisory function, while regtech is implemented by financial institutions to facilitate their reporting and compliance in terms of existing regulation to which they must adhere. Both forms of technology could aid supervision efficiency.

[25] FSB (n 1) 2. On third party service providers, also see par 4 below.
[26] FSB (n 1) 2 59.
[27] BCBS (n 1) 34. See also FSB (n 1) 3.
[28] BCBS (n 1) 34.
[29] See Schwarcz "Intrinsic imbalance: The impact of income disparity on financial regulation" 2015 *Law and Contemporary Problems* 97 shows that on average those working at US regulatory agencies earn half of what their counterparts in the private sector earn.
[30] Schwarcz "Towards more sustainable and less crisis-driven financial regulation" 2015 *University of St Thomas LJ* 427 433-434; Schwarcz (n 29) 106-107.
[31] BCBS (n 1) 34-35.
[32] BCBS (n 1) 42.
[33] BCBS (n 1) 42. See further Baxter "Adaptive financial regulation and regtech: A concept article on realistic protection for victims of bank failures" 2016 *Duke LJ* 567 598-603.

The speed of the response by supervisory authorities may prove important in future and speed could be aided by some incorporation of technology in supervision. The FSB warns that there may in future be pressure on both fintech businesses and on incumbent financial institutions to adopt new technology rapidly.[34] This could lead to exposure to greater risks without correct pricing. Such rapid change will have to be met with the capability of supervisory authorities to consider and respond quickly to financial stability as well as market conduct threats.

4 *Implications for regulatory frameworks*

Most jurisdictions have not implemented much sector specific regulation for fintech, but rather use their existing regulatory frameworks for the regulation of new fintech products and services, whether implemented through a current holder of a banking license or independently. This means that legacy regulation must cater for situations that cannot be adequately predicted.[35] This can and should be done both by drafting legislation in a manner that is resilient or adaptive to disruption, as well as by constantly monitoring for potential gaps in existing legislation.[36] These gaps typically occur when fintech companies start performing functions previously performed by banks, or where banks start to rely significantly on non-regulated activities.[37]

Even now, over half the members of the BIS reported that they are considering fintech-specific regulation. The FSB reported that more than half of the jurisdictions it surveyed have already taken, or plan to take, regulatory measures to respond to fintech.[38] These responses were mostly aimed at specific fintech developments, primarily crowdfunding or peer-to-peer lending activities, virtual currencies, payment services and cyber-security.[39] The main point is that supervisors should act pro-actively.

A further concern, is that current legislation may either lead to barriers to entry for new fintech firms, or may inadvertently result in a market lead for firms that find themselves outside the scope of existing regulation and are therefore able to function more cheaply. There are international examples where licensing

[34] FSB (n 1) 23.
[35] BCBS (n 1) 35.
[36] FSB (n 1) 19.
[37] BCBS (n 1) 37.
[38] FSB (n 1) 28 57-59. Participants included all the members of the FSB, including South Africa (the Reserve Bank), as well as Kenya and Pakistan. The FSB (57) indicates that consumer protection, market integrity, financial inclusion and the promotion of innovation and competition are the main policy objectives of these legislative measures. Financial stability was not often mentioned as a key objective, perhaps owing to the early phase of development of many of these technologies (58)
[39] FSB (n 1) 58. The SARB has recently published Guidance Note 4/2017 issued in terms of s 6(5) of the Banks Act 94 of 1990, in which it requests banks to assess their current cyber-security arrangements against the CPMI-IOSCO cyber-resilience guidance principles. See Committee on Payments and Market Infrastructures and Board of the International Organization of Securities Commissions *Guidance on Cyber Resilience for Financial Markets Infrastructures* (2016), available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD535.pdf (17-09-2017). These principles were drafted with a view of protecting market infrastructures, but the SARB is of a view that they are also relevant for the banking industry.

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requirements have been amended to remove barriers to entry and to stimulate innovation.[40] Amendments to the EU Payments Services Directive[41] will facilitate innovation in payment such as aggregation and payment initiation. The European Central Bank has set as one of its key objectives for 2017 the compilation of a uniform set of rules for the licensing of fintech firms across the European Union and publication of these rules is imminent.[42] In the United Kingdom, the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority have set up a New Bank Start-up Unit to encourage new entrants into the banking sector. Initial authorisation is granted to new entrants, with a limit of GBP 50 000 for deposits to limit the impact on the wider system. They must then deliver a mobilisation plan in order to move to a fully licensed bank within a year.[43] In the United States, the Office of the Comptroller of the Currency ("OCC") has published a document for comment concerning the creation of a special purpose national bank charter for fintech companies.[44] The Reserve Bank of India has issued restricted payment bank licenses to encourage financial inclusion.[45] These banks may only hold a maximum balance of USD 1 500 per customer and may not issue credit cards. Capital requirements are also relaxed for these banks. A key feature of these banks is that they are allowed to make remittances through various channels. In Switzerland firms no longer require a banking license for taking public deposits lower than CHF 1 million. The Swiss are also expected to introduce a new authorisation category for financial innovation.[46] This will only apply to business models that do not involve typical banking activity, but do include some elements of banking activity, such as deposit-taking. The Australian Securities and Investment Commission may grant a class waiver for fintech testing, subject to the meeting of eligibility criteria.[47] The service must not be offered to more than 100 retail customers, the total customer exposure is limited to AUD 5 mil and the waiver only runs for 12 months.[48] Strict eligibility requirements apply, which also means that a firm will outgrow very quickly the restrictions of the waiver.[49]

[40] BCBS (n 1) 47-48.

[41] Directive 2015/2366/EU of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC. The rules of the Directive apply from 13 January 2018.

[42] European Central Bank *ECB Banking Supervision: SSM Supervisory Priorities 2017* (15 December 2016) 2, available from https://www.bankingsupervision.europa.eu/ecb/pub/pdf/publication_supervisory_priorities_2017.en.pdf (14 -09-2017).

[43] For more about this, visit http://www.bankofengland.co.uk/pra/nbsu/Pages/default.aspx (15-09-2017).

[44] See https://www.occ.treas.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf (15-09-2017).

[45] Reserve Bank of India *Guidelines for Licensing of "Payments Banks"* (2014), available at https://rbi.org.in/scripts/bs_viewcontent.aspx?Id=2900 (15-09-2017).

[46] For more on this, visit https://www.finma.ch/en/authorisation/fintech/ (15-09-2017).

[47] ASIC Corporations (Concept Validation Licensing Exemption) Instrument 2016/1175 ss 5-7; ASIC Corporations (Concept Validation Licensing Exemption) Instrument 2016/1176 ss 5-7.

[48] Zetzsche, Buckley, Arner and Barberis *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation* (EBI Working Paper Series 2017 No 11) 42-43.

[49] Zetzsche et al (n 48) 43 note that the competitive benefits of the waiver will be best served if ASIC may allow for additional restricted licenses or class waivers when firms outgrow these boundaries. It is not clear at this point whether this would be done.

Two aspects are specifically highlighted by the BCBS – the risks presented by third party service providers and the applicability of licensing regimes to fintech firms.[50] Third party service providers of fintech to regulated banks may expose those banks to additional non-compliance risk, which means that they need to implement additional measures to monitor third party activities within the regulatory frameworks that apply to banks. Additionally, if the same third party provides services to many banks, they may become systemically significant. This is also the case when the bank's systems depend fundamentally on a service provided by a third party.[51] Such wide-scale reliance could pose its own contagion risks.[52] There are some limited international examples where bank supervisors have the authority to supervise such third party service providers directly,[53] but in most cases the third party contractually subjects itself to bank supervision in the agreement with the regulated bank. However, even then the supervisory authorities reported in most cases that they do not have formal supervisory programmes in place for such third parties, but make use of the power on an ad hoc basis.[54]

The South African Reserve Bank ("SARB") requires banks to include such a term in contracts with service providers that provide a "material business activity or function".[55] Such service providers must agree to provide regulatory and supervisory authorities unrestricted access to information held by those service providers, which is necessary for them to conduct their regulatory and supervisory functions. In the main, issues with third party service providers are seen as a managerial risk mitigation concern for the directors of a bank.

As for licensing, the BCBS concludes that while banking and other financial services are mostly subject to licensing requirements, completely new financial products and services tend not to be subject to licensing at all, or only to a limited extent.[56] Some of the developments in licensing regimes, which aim to stimulate competition in the market, have been discussed above.

It seems that a re-assessment of financial regulation is necessary, specifically with a view of drafting legislation that is resilient, or adaptive, enough to cope with rapid changes in technology and the disruption that such technology might cause. It must be assumed that legislators will not be able to foresee the nature of the technology or the specific impact it will have on regulated activities. Legislators work within the confines of bounded rationality.[57]

[50] BCBS (n 1) 36-38.

[51] Cloud computing is mentioned specifically in this vein by the FSB (n 1) 2 19.

[52] FSB (n 1) 12 14 22.

[53] See BCBS (n 1) 43-44 (Annex 2 "Indirect supervision of third party service providers") for a complete list of the members who have supervision measures in place.

[54] BCBS (n 1) 36.

[55] Guidance Note 5/2014 issued in terms of s 6(5) of the Banks Act 94 of 1990, par 6.2.5(z) and par 6.9.

[56] BCBS (n 1) 37 45-48 (Annex 3: "Licensing frameworks: comparative analysis for specific business models").

[57] "Bounded rationality" refers to the rationality most people will employ when faced with complex decisions bounded by time and incomplete information. It is not the rational ideal that leads to the best results, but leads only to satisfactory results when the mentioned constraints are considered. See Law (ed) *A Dictionary of Finance and Banking* (2014).

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To achieve the objective of resilience, regulation will have to meet three goals. First, there will have to be a move toward greater reliance on principle-based regulation as opposed to a strict rules-based approach. Secondly, financial regulation will have to be activity specific, rather than entity specific. Lastly, as far as possible, the regulation must be drafted in a technologically neutral manner.

4.1 Principles-based regulation

All legislation consists of a combination of principles and rules.[58] Rules convey the triggers for regulatory response and the results of a breach of the provision.[59] A clear rule ordinarily leaves very little discretion in the hands of the decision-maker, whether this is a judge, an alternative dispute resolution venue or a regulator. Actors in commercial settings appreciate the use of rules, because it provides *certainty* about outcomes and about the confines of operations. However, excessive use of rules may lead to regulatory arbitrage, as actors seek to model their actions outside of the ambit of regulatory provisions.[60] Another possible result of a strict rules-based approach is that actors adhere to the letter of the rule, but do not take stock of whether the mischief the rule attempts to exclude has in fact been addressed.

It cannot be denied that there has been a severe rules-based response to the global financial crisis.[61] This approach has substantially increased the complexity of already complex regulation. It has also necessitated the addition of even more staff to make sense of the regulation and to monitor compliance, leading to direct cost effects for those subject to the regulation. An exaggerated focus on rules rather than principles in regulation leads to an increase in complexity, rather than a decrease, despite the insistence by many that rules lead to certainty. Add to the mix complexity of products, which is typically the case when dealing with fintech, and one finds that senior managers do not always understand what their secondary, more technically savvy managers present to them.[62] It is doubtful whether the typical person appointed in compliance functions would do any better, which may signal a need to recruit persons with a strong technology background going forward.

Principle-based regulation "leaves both the trigger and the response to be determined by the decision-maker on the basis of an underlying evaluative

[58] Awrey "Regulating financial innovation: A more principle-based proposal?" 2011 *Brook J Corp Fin & Com L* 273 276.

[59] Awrey (n 58) 275.

[60] Awrey (n 58) 277; Baxter (n 33) 574-575.

[61] See in general Arner "Adaptation and resilience in global financial regulation" 2011 *North Carolina LR* 1580. For instance, the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. No. 111-203, 124 Stat. 1376) runs for 848 pages, excluding accompanying rules and forms. See Briefing "The Dodd Frank act: Too big not to fail" (18 February 2012) *The Economist*, available from http://www.economist.com/node/21547784 (28-09-2017). Reform to this legislation was one of the key promises of the GOP presidential election campaign in 2016. The result is that legislation to repeal sections of the Dodd-Frank Act (The Financial CHOICE Act of 2017 (H.R. 10)) has been approved by the US Congress and is currently serving before Senate. See https://www.congress.gov/bill/115th-congress/house-bill/10 (28-09-2017) for this Bill's progress and a summary of its main provisions.

[62] Schwarcz (n 29) 432.

framework."[63] Regulation identifies the regulatory outcomes that it aims to achieve and leaves it to the regulated actors to provide content to the policies and procedures necessary to achieve the outcome.[64] This means that the management of regulated actors must actively engage with regulation in order to ensure that the regulatory outcomes are met.[65] Such an approach to regulation inherently offers greater flexibility, because in each case the regulator must measure the proposed activity against the set evaluative framework, rather than a strict rule. This immediately means that advancements could potentially be covered by principles, even if they would escape the rules, thereby reducing the possibility of regulatory arbitrage.[66] Principle-based regulation also potentially enhances the resilience of the regulation, meaning that changes in technology need not immediately necessitate a change in regulation.[67]

It must be emphasised that principle-based regulation does not imply light touch supervision. Instead, it implies more active and in-depth supervision, characterised by constant dialogue and interaction between the regulator and the regulated.[68] Principle-based regulation implies that the regulator should be able to exercise discretion and should have sound judgment.[69] An overly risk-averse regulator would stifle all innovation in a principle-based regulatory approach.[70] Herein lies a real challenge for regulators and regulated actors, as a change in regulatory culture is necessary for principle-based regulation to come into its own.

Part of this new regulatory culture is an acknowledgement that regulation need not only emanate from state action, but could also be imitated through the interaction between state and regulated actors.[71] The constant communication between the regulator and the regulated leads to the flagging of aspects in need of closer monitoring, but also alerts the regulator to risk that a hard stance in regulation could eliminate the business and consumer benefits of the products proposed.[72] This facet could be especially valuable in the context of fintech

[63] Awrey (n 58) 275.
[64] Awrey (n 58) 286.
[65] Awrey (n 58) 288.
[66] Awrey (n 58) 278.
[67] Awrey (n 58) 293 refers to this as the "durability" of regulation. See further Baxter (n 33) 588.
[68] Baxter (n 33) 579. Supervision of this type of regulation is typically costlier (see Awrey (n 58) 294), which combined with the problem of income disparity described above (par 3), poses real challenges especially in jurisdictions with budgetary constraints.
[69] Following on his findings on the income disparity between regulators and those working in the private sector, Schwarcz (n 29) 108-109 questions whether those with the best judgment always make it into government agencies. He arrives at this question by assuming that good judgment also carries value for an organisation, which means that enterprises would pay to obtain the services of those who best display it. Knowing that government agencies cannot compete to offer the best reward for such persons, one must then ask whether they end up in supervision. He concludes with the following anecdotal statement: "… many of the bright financial regulators I have met tend to be very narrow and rigid, seeing problems in black and white and often lacking the flexibility to try to see others' perspectives." On the other hand, Baxter (n 33) 577-578 shows that regulators already exercise extensive discretion, especially in bank supervision.
[70] Awrey (n 58) 295.
[71] Awrey (n 58) 283-285.
[72] Awrey (n 58) 285 288 - 289 refers to this as "sophisticated dialogue, shared understandings".

regulation and it seems that the initiatives for the facilitation of innovation discussed below indicate that regulators already grasp its worth.[73]

At its best, enforcement action would be reduced, because regulators would be able to guide actors away from infringing behaviour before its occurs.[74] However, that is not to say that vigorous enforcement does not form part of principle-based regulation. While the aim is to reduce the incidence of non-compliance through dialogue, the success of this aim is highly dependent on mutual trust between the regulator and the regulated actors, as well as trust by the public that effective supervision is still present. The presence of vigorous enforcement also incentivises regulated actors to keep their end of the bargain - to put effective policies and procedures in place to comply with and monitoring compliance of the regulated outcomes.[75] Those who intentionally breach the trust with the regulator by acting outside the dialogue created must be dealt with swiftly by appropriate enforcement action.

Not everyone is keen on principle-based regulation. Arguments against it usually refer to the lack of predictability and certainty that this approach could hold, which may in turn lead to risk-averse behaviour.[76] Furthermore, owing to the greater discretion that regulators hold in the process there is the risk of abuse of discretion. There is also a risk of regulatory capture, meaning that the relationship between the regulator and the regulated over time becomes too close and loses objectivity.[77] The latter problem may, however, be addressed through normal governance best-practice. Finally, some argue that principles tend to mutate in time into rules, as the standards and policies developed by industry become generally accepted and adopted.[78]

This having been said, it seems that there is a growing recognition that we need to rethink the extent to which rules form the base of our financial regulation. The FSB included a specific question in its survey on the extent to which the respondents' regulations made use of principles-based regulation as opposed to rules-based regulation.[79] The replies indicated that a mix of principles and rules are mostly employed, although there is recognition from some that principle-based regulation might be more apt when the fintech is nascent.[80]

The point was made above that regulators need to be pro-active in providing for effective regulation to address the potential current and future impact of fintech. However, pro-active financial regulation has not been the norm. Instead, regulation in this field typically occurs as a response to crisis and the response

[73] Par 5.

[74] Schwarcz (n 29) 110 refers to this as "informal enforcement action", which often does not amount to more than a raised eyebrow, but is enough to keep behaviour in check.

[75] Awrey (n 58) 289-290.

[76] Awrey (n 58) 278.

[77] Awrey (n 58) 296. Baxter (n 33) 581 raises the point that often the actions of regulated actors, in this case banks, have been impliedly approved by regulators owing to the close working relationship between banks and regulators. This makes litigation by private parties who fell victim to bank failure more difficult.

[78] Awrey (n 58) 295-296, also referred to as "regulatory creep".

[79] FSB (n 1) 57.

[80] FSB (n 1) 59. See also the comments by Zetzsche et al (n 48) 54-55.

is usually politically motivated.[81] One consequence of crisis regulation is that the regulator is seen, and must act as, a strict enforcer of the regulation that is enacted to plug the hole that led to the particular crisis.[82] Crisis regulation therefore tends to lead to adversarial regulatory relationships, rather than the cooperative model that is proposed through principle-based regulation.

4.2 Activity-based regulation

Regulation must be activity specific and not entity specific.[83] This does not mean that the emphasis on considering the financial well-being of financial conglomerates that became prominent after the global financial crisis falls away. Rather, it means that the net of consideration must be cast wider to include non-bank service providers on which banks rely extensively in their operations. For instance, even a cursory look at the current regulation of financial conglomerates in the Financial Sector Regulation Act[84] shows that there is very little scope in the legislation to look beyond the borders of the holding company-subsidiary relationships of what is traditionally considered a company grouping.[85] However, prudential regulation is not concerned with company groupings. It is concerned with all the systemically important contributors to the welfare of a financial institution and this may well be a third party-service provider outside of the group.

4.3 Technologically-neutral regulation

Regulation must, as far as possible, be technology neutral.[86] Going hand-in-hand with the previous two points, regulation must as far as possible not attempt to name particular technologies, but should rather be phrased to state the principles that must be adhered to in order to retain the soundness of the governed activities. This does not imply that regulators should not study and understand technology or its implications for supervision, but rather that the regulation itself must be encompassing enough to cater for new innovations that deliver the same functionality.

[81] Schwarcz (n 30) 427; Baxter (n 33) 585-586.
[82] Baxter (n 33) 586-587 594-595.
[83] BCBS (n 1) 38; FSB (n 1) 3.
[84] ss 160-166 of the Financial Sector Regulation Act 19 of 2017.
[85] In terms of s 1 of the Companies Act 71 of 2008 a "group of companies" is a "holding company and all of its subsidiaries". A "holding company" is a juristic person that controls that subsidiary as a result of the circumstances set out in ss 2(2)(*a*) or 3(1)(*a*) of the Companies Act. The latter sections provide that the right of, or control over, the majority of the voting rights of securities in a company, or the right to, or control over, the election or appointment of directors with a majority of the voting rights at a board meeting of the company, would constitute "control" for purposes of the definition. See also s 1 of the Financial Sector Regulation Act 19 of 2017.
[86] See, for instance, Principle 21 of the EU Payments Services Directive (n 26): "The definition of payment services should be technologically neutral and should allow for the development of new types of payment services, while ensuring equivalent operating conditions for both existing and new payment service providers." See further FSB (n 1) 3; Zetzsche et al (n 48) 54-55; Tuba "The technology-neutral approach and electronic money regulation in the EU: identifying the promises and challenges for future regulation in South Africa" 2014 *CILSA* 372 381-383.

The concept of technological neutrality in regulation is not new. It has been adopted widely in the regulation of electronic communications, mostly to aid the objective of functional equivalence – that is, regardless of the form of electronic communication it should carry the same acknowledgement as traditional hard copy communications.[87] In financial regulation, the aim is also functional equivalence – the same rules should apply when the outcome is the same activity.

5 *Facilitation of innovation*

An additional approach to fintech regulation is for supervisory authorities to offer active support to innovation while keeping a regulatory eye on the progress. Current trends in this vein are innovation hubs, accelerators and "regulatory sandboxes".[88] Regardless of the manner in which the interaction takes place, regulatory agencies use these avenues to engage with fintech firms actively and to provide guidance on how to operate within the current regulatory framework. Part of the aim of these initiatives is to collect better data on fintech developments so that supervisory authorities may foresee potential regulatory shortcomings.[89] These initiatives also signal to the market that regulators are willing to engage with innovators.[90]

The term "innovation hubs" is widely defined to refer to a range of mechanisms in which fintech firms, as well as current banks with an innovation initiative, come together with regulators to discuss advancements.[91] Interaction remains informal at these events, but regulators can gain valuable insight into new developments and the possible challenges that these may pose for supervision. At the same time, fintech firms may gain a sense of the acceptability of their idea within the current regulatory framework. Some regulators host hubs inside their own structures, within which they invite fintech firms to liaise with them about regulatory compliance.[92]

Accelerators refer to the practice where private firms invite public participation to come up with an innovative solution to a particular problem. This may

[87] See for instance the Electronic Communications and Transactions Act 25 of 2002, s 2(*f*): "The objects of this Act are to enable and facilitate electronic communications and transactions in the public interest, and for that purpose to promote technology neutrality in the application of legislation to electronic communications and transactions." See further the United Nation Convention on the Use of Electronic Communications in International Contracts of 2005.

[88] BCBS (n 1) 38-40; FSB (n 1) 3 58.

[89] FSB (n 1) 59.

[90] Zetzsche et al (n 48) 60.

[91] BCBS (n 1) 39-40. The FSB (n 1) 58 cites the FinTech Support Desk in Japan and the Fintech Centre in South-Korea as examples. See also Zetzsche et al (n 48) 8-11 for a more detailed list of the 21 jurisdictions that have included innovation hubs in their regulatory approach. The SARB does not appear on the list.

[92] For instance, the Australian Securities and Investment Commission hosts an innovation hub. One of the particular areas where this innovation hubs invites private sector interaction is the in the development of regtech. See http://asic.gov.au/for-business/your-business/innovation-hub/ (17-09-2017).

culminate in a hosted event where the proposed solutions may be presented.[93] Regulators may become involved in accelerators either by hosting (the invitation of solutions to suptech, for instance) or by attending the presentations.

"Regulatory sandboxes" refer to the live testing of innovations in a controlled environment.[94] In its report that preceded the implementation of a regulatory sandbox, the United Kingdom FCA cited three potential benefits that sandboxes could deliver.[95] First, the use of a sandbox could potentially reduce the time it takes to take a product to market and do so at lower costs. This is because it alleviates the regulatory uncertainty that may discourage innovators. Secondly, it will increase the firms' ability to access finance. Evidence from other sectors, notably the pharmaceutical industry, showed that regulatory uncertainty leads to a significant reduction in the availability of financing. Lastly, it will encourage the trial of new products and could lead to more products entering the market, which will benefit consumers.

While innovation hubs and accelerators operate informally, sandboxes entail the formal cooperation of regulators, usually preceded by an application process. During the application process, applicants must usually show that they support the financial services industry, provide genuine innovation and that they benefit consumers.[96] Regulators must further determine whether the applicant needs the sandbox, or whether their activities are already sufficiently regulated by existing regulation.[97] Some sandboxes deny access to already licensed firms. Others allow entry, especially if there is collaboration between an existing firm and a new fintech entrant.[98] The approved fintech firms may be given restricted licenses to conduct financial services activities. Approved firms operate under restrictions during their time in the sandbox. This may include restrictions as to the target of the business model, with enhanced restrictions being the norm where retail customers are targeted.[99] Time restrictions often apply.[100] Firms must provide the regulator with an approved exit strategy so that obligations to customers are honoured before they leave the test environment.

[93] For instance. Westpac hosts a yearly competition where they challenge businesses to come up with an innovative technological idea in a particular sector. See http://www.westpacinnovation.com.au/about/ (17-09-2017). This year the focus sector was professional services and the winner was Checkbox, which is described as "a technology start-up company that enables experts to transform complex regulation into easy-to-use software in the cloud without a developer." See https://www.westpac.com.au/about-westpac/media/media-releases/2017/8-september/ (17-09-2017). Barclays runs an accelerator from Cape Town. See http://www.barclaysaccelerator.com/#/cape-town/ (30-09-2017).

[94] BCBS (n 1) 40; Zetzsche et al (n 48) 13-14. See in general Financial Conduct Authority *Regulatory Sandbox* (2015) available at https://www.fca.org.uk/publication/research/regulatory-sandbox.pdf (30-09-2017).

[95] FCA (n 94) 5.

[96] Zetzsche et al (n 48) 30-31; FCA (n 94) 7.

[97] Zetzsche et al (n 48) 32.

[98] Zetzsche et al (n 48) 33-34. The FCA (n 94) 8-9 created restricted authorisation for unauthorised firms that needs to use the sandbox, but in the case of authorised firms, it may grant waivers or no-enforcement action letters to allow for leniency during the testing and pilot phase of the new product. This type of leniency is not strictly speaking a sandbox and Zetzsche et al (n 48) 47 note that it is often hard to tell where the testing and piloting phase ends and the regular (and to be regulated) activity begins.

[99] Zetzsche et al (n 48) 34-35.

[100] Zetzsche et al (n 48) 35-36.

While in the sandbox, firms are subject to more lenient regulation. However, the scope of the relaxation of applicable rules differs significantly between the different sandboxes.[101] Furthermore, a lack of transparency of the relief granted in the sandbox is flagged as a key of concern regarding the current sandbox practices.[102] It is not always clear to established firms what relief has been granted to firms in the sandbox, which increases the risk of unequal regulation after the sandbox firms exit. Ideally, established firms would be able to ask for a similar dispensation when they want to engage in a particular innovation.

A sub-category of the regulatory sandbox is the sandbox umbrella.[103] In this model a non-profit company is established by industry to act as an umbrella sandbox. The umbrella company must be authorised like all other financial institutions and is supervised as such, but will then allow innovators to act under it as representatives. The assessment of the suitability of innovators to be allowed under the umbrella is then made by the umbrella company and not by the regulator, which is intended to save time on the side of the innovators. Additional advantages could be that the testing is done in real time and on a greater scale and that the innovator's current customer base need not be exposed to the innovation being tested.[104] Also, if the benefits of the innovation could apply across board for competitors, it may provide a useful avenue for collaboration to share in the reduction of costs that this might present.[105] Examples could include digital identity and authentication systems, settlement chains and regtech solutions.

There are, however, real challenges to the use of sandbox umbrellas.[106] First, there is the risk that liability might follow for the umbrella company if one of the representatives causes prejudice through its actions. Secondly, the umbrella company would only be able to operate with a focus on limited services, which limits its use, Thirdly, there will be considerable complexity in running the umbrella company and it is not clear who will bear the costs associated with this, or whether it will benefit the representatives in the end as opposed to running a simulation, say, in a virtual sandbox.[107] In the end companies will still want to enjoy a competitive edge on their peers, which might be lost when collaborating under an umbrella.

Regulatory sandboxes have gained quick traction, especially in the eastern hemisphere, with Australia, Singapore, Hong Kong, South Korea and Indonesia taking this approach on board.[108] However, the concern has been expressed that

[101] Zetzsche et al (n 48) 36-37.
[102] Zetzsche et al (n 48) 40.
[103] FCA (n 94) 13; Zetzsche et al (n 48) 45-47.
[104] Zetzsche et al (n 48) 45. These commentators see the sandbox umbrella being especially useful to test risk and compliance regtech functions, which they predict might not get established without such an imitative. Financial institutions might otherwise not be willing to take the risk of non-compliance when the regtech solutions turn out not to deliver the required outcomes.
[105] Zetzsche et al (n 48) 46.
[106] Zetzsche et al (n 48) 47.
[107] On virtual sandboxes, see FCA (n 94) 12.
[108] See Zetzsche et al (n 48) 27-29 for a complete list as at August 2017.

they are not scalable in their current form.[109] Very few entrants are allowed into operational sandboxes, perhaps because of the reputational risk to regulators and because it is often difficult to show that the product really brings innovation. Zetzsche et al raise the very valid point that fintech companies often fail to satisfy the fit-and-proper person tests necessary to be granted licenses, because of the lack of experience of the operators.[110] This is not remedied within the six to twelve months within a sandbox and usually means that they need experienced outsiders on board in any event before they can be granted a final license. They further raise the possibility that regulatory sandboxes are not being used because the relaxed licensing or waiver regimes already in operation in many jurisdictions make them superfluous.[111]

6 *Conclusion*

The advance of fintech is receiving a lot of attention currently and it seems as if most commentators reach similar conclusions. First, they all agree that there will be disruption to the business models of banks and other financial institutions as the innovations in this field become mature. The exact extent or form is less important than this one reality. Secondly, regulators should act pro-actively in their engagement with these developments. This holds implications both for the supervision of financial institutions as well as for the future regulation of financial institutions.

Strong domestic and international cooperation between supervisors will be necessary to ensure that effective supervision occurs across industries and cross-jurisdictionally. The recruitment and training of employees of supervisors must be adjusted to include technological training and experience. It was noted that budgetary constraints may work against this objective, but this is a factor for supervision generally. Finally, technology may assist supervision if incorporated in supervision activities (suptech) or as a means of enhancing reporting and disclosure by regulated actors (regtech).

Many countries are either considering regulation in the fintech domain, or have adopted specific legislation already. The concern with financial regulation is to foster innovation and the competitive and consumer benefits it delivers, while mainlining the stability of the financial system and proper consumer protection. Some countries have adopted flexible licensing arrangements in order to promote fintech. Of specific concern are third-party service providers of fintech to incumbent banks who might not fall under existing regulatory regimes, but become systemically significant because of the reliance of the market on their systems.

Three key areas of attention in future financial regulation are identified. First, there ought to be a renewed look at the use of principles rather than rules as a staple of financial regulation. The flexibility and durability, or resilience,

[109] Zetzsche et al (n 48) 13 49-50.
[110] Zetzsche et al (n 48) 49-50.
[111] Zetzsche et al (n 48) 59. See also par 4 above.

of principles as opposed to rules fit the dynamic nature of the technological advancements made in finance. It is acknowledged that this would require a cultural shift on the side of both regulators and regulated actors away from the current adversarial method towards an approach based on continued dialogue and cooperation. It is further acknowledged that this approach is an intensive and more costly method of supervision, which faces budgetary concerns. Secondly, future regulation will have to focus on the regulation of financial services activities, rather than on the regulation of legal entities. Thirdly, regulation will have to be technologically neutral in order to provide flexibility needed for innovations that cannot be foreseen.

As an adjunct to the potential change in the manner of regulation, many regulators now engage innovators through the use of innovation hubs, accelerators and regulatory sandboxes. These initiatives were discussed briefly. While it seems that none of them could offer a final solution to the potential regulatory barriers to entry that fintech firms may face, they do at the very least signal the willingness of regulators to engage with innovation and may lead to enhanced understanding on both sides. Fintech firms may gain a better understanding of the requirements they need to meet in order to obtain full licensing and the regulator may come to a better understanding of the technology it might encounter in the near future.

It is submitted that all of these aspects need to be considered by the newly reorganised financial regulatory sector in South Africa. A mention of South Africa is noticeably absent from all of the documents discussed above, while other African countries, such as Mauritius and Kenya have already moved to incorporate some of these principles.[112] This is despite the fact that South Africa is said to have the most fintech start-ups in Africa.[113] Competition is not only a consideration for market players. It is also a consideration for jurisdictions who want to create a favourable regulatory framework to encourage business to base its operations from inside that country.[114] This does not suppose a lax framework, simply one that does not throw unnecessary hurdles in the way of progress.

[112] See, for instance, http://www.investmauritius.com/news-room/latest-news/uk-mauritius-fintech-conference-2017-positioning-mauritius-as-the-fintech-hub-of-africa.aspx (30-09-2017). There is some indication that the SARB is looking into greater fintech interaction. See https://cfo.co.za/profiles/blogs/reserve-bank-talks-up-fintech-regulation (30-09-2017) and https://www.moneyweb.co.za/news/tech/sarb-outlines-fintech-regulatory-approach/ (30-09-2017).

[113] See https://www.forbes.com/sites/mfonobongnsehe/2017/06/15/payment-startups-lead-way-in-africas-booming-fintech-scene/#3b8745d524d1 (30-09-2017).

[114] See in this regard Pan (n 6) 807.

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The Financial Intelligence Centre Amendment Act and the application of a risk-based approach

WYNAND SPRUYT*

1 *Introduction*

After numerous delays and challenges, the Financial Intelligence Centre Amendment Act (FICAA)[1] was finally signed into law on 26 April 2017 and gazetted on 2 May 2017.[2] The Minister of Finance subsequently announced three commencement dates on which the different provisions of FICAA would be implemented.[3] On the first of these – 13 June 2017 – all provisions were implemented that did not require changes to existing regulations, exemptions or the internal systems that enable accountable institutions to comply with the Financial Intelligence Centre Act (FICA).[4] The second commencement date of 2 October 2017 resulted in the majority of the provisions being implemented.[5] These amendments gave effect to new concepts and approaches, or required changes to existing regulations and exemptions under FICA, as well as significant changes to the compliance processes and systems used by accountable institutions. The commencement date for the remaining provisions – which primarily relate to the freezing of assets in terms of United Nations Security Council Resolutions on targeted financial sanctions,[6] as well as limited aspects of Schedule 3A[7] – is still to be determined.[8]

* B.Acc LLB (Stell), LLD candidate (Stell). Regulatory & Conduct Risk Management, FirstRand Limited.

1 of 2017.

2 *GG* 40821 (02-05-2017).

3 https://www.fic.gov.za/Documents/FIC_Act_Commencement_14June2017.pdf (13-06-2017).

4 38 of 2001.

5 *GG* 41153 (29-09-2017); *GG* 41154 (29-09-2017).

6 As per the Minister, the delay on sections 26A to 26C is to enable consultations within Government and allow for internal systems development.

7 Schedule 3A of FICA sets out different categories of "domestic prominent influential persons". When entering into business relationships with such clients, accountable institutions must comply with the additional requirements now contained in s 21G. Although the provisions relating to domestic prominent influential persons were implemented on 2 October 2017, the requirements pertaining to companies doing business with the State, as included in the scope of Schedule 3A, will require operationalising later by notice, once a monetary value threshold has been finalised and the State is able to generate a database or capability to identify such companies. National Treasury is currently working with the Chief Procurement Office in this regard.

8 The Minister has indicated that the third commencement date is expected to be set for no later than the end of 2018.

The amendments to FICA are aimed at strengthening the South African regulatory framework for anti-money laundering (AML) and the combating of the financing of terrorism (CFT). The amendments also ensure that the South African framework is now more closely aligned to the 40 Recommendations issued by the Financial Action Task Force (FATF) – the global standard for AML/CFT compliance, risk management and enforcement.[9]

Although the scope of the amendments is broad and the newly introduced requirements are diverse and varied, most of the amendments can be categorised as relating to client due diligence (CDD). The purpose of CDD is for an accountable institution to know who its clients are and to understand the business that clients are conducting with the institution.[10] This understanding is achieved through client identification and verification measures (CIV) – commonly also referred to as "know your client" or KYC-requirements – as well as on-going due diligence, which includes on-going monitoring; the periodic refresh of client information; and the regular review of certain categories of clients, such as those representing a higher risk of money laundering, terrorism financing or related forms of financial crime.[11]

Specifically now included in the scope of CDD is the identification of beneficial owners,[12] to prevent natural persons from misusing legal entities for purposes of money laundering and terrorism financing;[13] requirement relating to business relationships with foreign prominent public officials and domestic prominent influential persons respectively;[14] as well as additional controls to ensure that accountable institutions fully understand the nature and potential risk posed by their clients.[15]

Amendments were also introduced to provide for the implementation of the United Nations Security Council Resolutions on the freezing of assets relating to persons associated with terrorism;[16] the safeguarding of personal information, in line with the requirements of the Protection of Personal Information

9 The FATF is an intergovernmental organisation which develops policies and standards to combat money laundering and the financing of terrorism. South Africa is currently a FATF member state.

10 See FATF Recommendation 10 ("Customer Due Diligence and Record-Keeping"), as well as the Interpretive Note to Recommendation 10.

11 See s 21-21H of FICA, as amended.

12 As per s 1 of FICA, a beneficial owner, in respect of a legal person, means a natural person who, independently or together with another person, directly or indirectly (a) owns the legal person; or (b) exercises effective control of the legal person.

13 s 21B.

14 s 21F, s 21G. In general terms, such persons are typically described as "politically exposed persons" or "PEPs". PEPs are individuals who are or have in the past been entrusted with prominent public functions in a particular country. International standards issued by the FATF recognise that PEPs, as well as their immediate family members and persons known to be close associates, may be in a position to abuse their public office for private gain and may use the financial system to launder the proceeds of this abuse of office, and should in this basis be subjected to enhanced risk mitigation controls and measures. See the FATF guidance document "Politically Exposed Persons (Recommendations 12 & 22)" (2013) in this regard.

15 s 21A.

16 s 26A-26C.

Act;[17] inspection powers for regulatory compliance purposes;[18] and enhanced administrative and enforcement mechanisms.

However, the most significant amendment to the South African AML/CFT regulatory framework is without a doubt the introduction of the risk-based approach to the identification and assessment of money laundering and terrorist financing risks.

2 *The risk-based approach*

It is trite that no amount of resources, controls or preventative measures can completely ensure that the financial sector is not abused for purposes of money laundering and the financing of terrorism. Therefore, an effective AML/CFT framework should rather ensure that resources are effectively channelled to and concentrated on areas that represent a higher risk of abuse.[19] Consequently, it should also be possible to devote less resources where the risk is lower. By applying enhanced measures and controls where the money laundering (ML) and terrorism financing (TF) risks are higher, with the option of applying simplified measures where the risks are lower, accountable institutions can target their resources more effectively, whilst ensuring that these risks are efficiently mitigated. The application of resources that are commensurate to the risks that are being managed and mitigated, can be described as a risk-based approach.[20]

The risk-based approach represents the antithesis of a rules-based approach – *i.e.* the application of prescriptive regulations and comprehensive risk management and compliance requirements. Instead of setting absolute minimum requirements, the risk-based approach serves to enable an accountable institution to make risk-informed decisions with regard to the management of its unique risks.

It is important to note that the risk-based approach does not exempt accountable institutions from mitigating ML/TF risks where these risks have been assessed as low, or from complying with minimum regulatory requirements.

The risk-based approach is not completely new to the South African AML/CFT regulatory framework. Although the requirements contained in FICA prior to the amendments, as well as the highly-detailed regulations to the Act, were highly prescriptive, the Financial Intelligence Centre (FIC) issued two guidance notes that provided limited scope for the application of a risk-based approach. In terms of Guidance Note 1, institutions were not required to follow a one-size-fits-all approach in the methods they use and the levels of verification

[17] 4 of 2013. See s 41A of FICA.

[18] s 45A-45B.

[19] In this context, "resources" not only refers to finances or human capital, but also to the various AML/CFT requirements, systems, controls and preventative measures that are adopted to protect the integrity of the financial system.

[20] See FATF Recommendation 1 ("Assessing risks and applying a risk-based approach"). The FATF regards the risk-based approach as an essential foundation for the efficient allocation of resources. Also see the FATF guidance document "Guidance for a risk-based approach: The banking sector" (2014) 3-7.

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they apply to all relevant clients.[21] Guidance Note 3A provided further guidance as to how this limited measure of judgement should be applied by accountable institutions.[22] However, despite these guidance notes, the strictly formulated requirements of FICA and its regulations significantly limited the application of a true risk-based approach and risk-informed decision-making.

This position has changed significantly. The preamble to FICA now specifically states that the Act provides for a risk-based approach to client identification and verification, and, although the Act itself contains very little detail on the risk-based approach itself, the FIC's newly issued Guidance Note 7 contains much of this detail.[23]

Although the risk-based approach implies less regulation, fewer prescriptive requirements and more flexibility, it also introduces uncertainty and a need for guidance. Such an approach furthermore introduces a new set of requirements. Risk-informed decision-making requires clear application of mind and the thorough documenting of all decisions taken in terms of this approach, as well as the rationale on which it is based. The risk-based approach therefore does not constitute a free-for-all in terms of AML/CFT risk management and compliance. If anything, the risk-based approach implies the need for maturity and rationalism when making risk-informed decisions.

3 *Application of a risk-based approach*

Fortunately, the methodology for the application of a risk-based approach is largely intuitive and simple to apply.[24] At the core of this methodology is the identification and assessment of ML/TF risk.

Risk in this context refers to the possible threats and vulnerabilities that could lead to an accountable institution's systems, processes or other elements of the business being abused for purposes of money laundering, terrorism financing, and international sanctions circumvention, which could also include weapons proliferation.[25] By understanding the scope and nature of these risks, accountable institutions can make informed decisions as to the appropriate methods and controls that should be applied in any given circumstance.

The following distinct steps form the basis for the application of a risk-based approach:

[21] Financial Intelligence Centre Guidance Note 1 "General Guidance Note Concerning Identification of Clients" 2.

[22] Financial Intelligence Centre Guidance Note 3A "Guidance for accountable institutions on client identification and verification and related matters" 4-8.

[23] Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 7-29.

[24] See FINTRAC "Guidance on the Risk-Based Approach to Combatting Money laundering and Terrorist Financing" (2016); FATF "Guidance for a risk-based approach: The banking sector" (2014); Financial Services Authority "Review of firms' implementation of a risk-based approach to anti-money laundering (AML)" (2008); Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 7-29.

[25] See Guidance Note 7 par 13.

3.1 Identification and assessment of inherent risk

The application of a risk-based approach firstly entails assessing the *inherent risk* faced from a money laundering and terrorism financing perspective. Inherent risk is the risk of an event or circumstance that exists before controls or mitigation measures are applied.

Risk in this context can be described as function of the *likelihood* and *impact* of uncertain events on set objectives.[26] The likelihood and impact of such events should be analysed in terms of *threats* and *vulnerabilities*. Guidance Note 7 provides the following definitions in this regard:

> "A threat is a person or group of people, object or activity with the potential to cause harm. In the context of money laundering and terrorist financing this includes criminals, terrorist groups and their facilitators, their funds, as well as any past, present and future money laundering or terrorist financing activities.[27]
>
> The concept of vulnerabilities comprises those things that can be exploited by the threat or that may support or facilitate its activities. Identifying vulnerabilities, as distinct from threats, means focusing on, for example, the factors that represent weaknesses or features that may be exploited in any given system, institution, product, service, etc."[28]

Risk in the AML/CFT context therefore refers to "the likelihood and impact of money laundering or terrorist financing activities that could materialise because of a combination of threats and vulnerabilities manifesting in an accountable institution",[29] or that may jeopardise the detection, investigation or prosecution of these activities or the possibility of the forfeiture of proceeds of unlawful activities.

An assessment of inherent risk requires that ML/TF risks are identified that may materialise in the context of an accountable institution's business, together with an assessment of the impact that such risks could have on its operations. It is important to note that there is no prescribed methodology for the assessment of these risks. However, the assessment of ML/TF related risks is typically done on the basis of specific risk variables or factors that may be indicative of ML/TF risk. These variables include the following:[30]

i. The product or service offering of the accountable institution, and specifically the potential for such products and services to be abused for ML/TF purposes;[31]
ii. the risk posed by the geographic areas in which the business operates, or in which its clients are based;[32]

[26] Guidance Note 7 par 8.
[27] Guidance Note 7 par 10.
[28] Guidance Note 7 par 11.
[29] Guidance Note 7 par 13.
[30] See Guidance Note 7 par 16-22 for an extensive list of possible risk indicators relating to each of these factors.
[31] Typically, transactional products represent a higher risk of money laundering (by facilitating the placement of illicit funds into the financial system and the consequent layering of such funds to obfuscate the origin thereof) and terrorism financing (by facilitating the transfer of funds, specifically including the facilitation of cross-border payments). Other high risk products include products or services that facilitates the transfer of cash or that provides anonymity to the parties to a transaction.
[32] High risk geographies would include jurisdictions with deficient AML/CFT frameworks and regulatory requirements, known tax havens, or jurisdictions subject to international sanctions.

iii. the delivery channels utilised by the accountable institution for purposes of *inter alia* client contact or client on-boarding;[33]

iv. the industry in which the accountable institution or its clients operate;[34] and

v. the inherent risk profile of the accountable institution's client base.[35]

These factors are relevant for purposes of two distinct types of risk assessments, as set out below:

i. Business-based risk assessments

The purpose of a business risk assessment is to assess the inherent ML/TF risks faced by the specific accountable institution, in order to design effective and appropriate controls to mitigate this risk to an acceptable level. Through these assessments, accountable institutions should identify the ML/TF risks they may face in the context of their business and analyse these with a view to understand the likelihood of the risk materialising and the impact that this would have. The outcome of a business risk assessment will therefore have a significant impact on the design of the policies, procedures and processes adopted into an accountable institution's risk management and compliance programme.[36]

The assessment must identify the manner and extent to which ML/TF risk can occur within the various elements of the business. This must be done by, for example, examining the business' product range; client profiles; client business activity; delivery channels; geographic locations; the recurrence of suspicious or unusual activity; financial crime typologies; adverse media; adequacy and effectiveness of existing controls (including the vulnerability of management override and potential schemes to circumvent existing control activities); the level of compliance with legal and policy requirements; internal and external audit reports; the level of reliance on third parties; and relevant AML/CFT legislation in a particular jurisdiction.

A business risk assessment could utilise a combination of internal subject matter experts; the business risk function; available publications; and external advice. It could also incorporate any future initiatives, as well as previously reported ML/TF incidents or events, issues and control failures identified by the respective assurance functions. The assessment must be dynamic and responsive to current and emerging risks.

[33] In general, face-to-face interaction between a client and an accountable institution would represent lower ML/TF risk than would be the case in a non-face-to-face environment.

[34] Some industries – such as dealers in precious metals, stones, scrap metal and second-hand goods; correspondent banking; and the sale of high-value goods such as art or real estate – inherently represent higher ML/TF risks, due to factors such as cash-intensity, client anonymity and the high-volume transfer of value.

[35] Certain clients automatically represent heightened ML/TF risks, such as politically exposed persons (see footnote 13 above) or clients subject to adverse media.

[36] See par 4 1 below in this regard.

ii. Relationship-based risk assessments

The application of the risk-based approach furthermore requires that the ML/TF risk posed by each client relationship should be assessed on an on-going basis. Relationship-based risk assessments – or client risk profiling – should, where possible, be done at the time of on-boarding, or as soon as possible thereafter; as well as on a periodic basis for the duration of the client relationship life-cycle.

Client risk profiling entails assigning different categories to different levels of risk per a risk scale and classifying the ML/TF risks pertaining to different relationships or client engagements in terms of the assigned categories. Typically, three risk categories are used for client risk rating: *low*, *medium* and *high* risk.

The initial risk assessment should at a minimum incorporate all relevant and available static client data obtained through the application of the required client due diligence measures (*i.e.* factors relating to inherent client risk; product; geography; industry; and distribution channels). However, while a risk assessment should be performed at the inception of the client relationship, a comprehensive risk profile of the client will typically only become evident once the client has begun transacting through an account or begins utilising a service or product. The monitoring of transactions, other client behaviour, and the business relationship as a whole, are therefore important elements of a well-designed risk-based approach. Once a client has been risk rated, this rating must therefore be continuously re-assessed for the duration of the client relationship life-cycle.

It is imperative that the ML/TF risk in any given circumstance be determined on a holistic basis. In other words, the ultimate risk rating accorded to a client relationship or transaction must be a function of all factors that may be relevant to the combination of a client profile, product type and transaction.

3.2 Creating risk-reduction measures and controls

Once the applicable inherent risks have been identified and assessed, these risks must be managed and mitigated. Risk management is done by either transferring, tolerating, treating or terminating different risks.[37]

In order to mitigate the risks identified and assessed, accountable institutions can implement a range of risk mitigation measures and controls, which typically includes the following:

- Risk management and compliance frameworks, policies and standards, incorporating the risk-based approach;
- risk management and compliance processes and procedures, including key controls implemented in the first and second lines of defence and which are properly documented in supporting operating standards and procedures;
- strategic technical solutions that provide for automation of core processes in the first and second lines of defence, and incorporating risk-based rules and configurations;

[37] Guidance Note 7 par 24.

- independent assurance, including risk-based, comprehensive, accurate and timely control testing and monitoring;
- adopting an organisational structure and design that ensures that adequate resources are allocated for risk management and compliance purposes;
- accountable executive(s) accepting overall responsibility for the institution's risk management and compliance programme; and
- governance and oversight, including by the board of directors and board-approved committees.

Although the application of a risk-based approach primarily impacts the measures and controls applied in terms of client due diligence,[38] such an approach could also have implications for a number of other control categories. Such controls could include the following:

- Increased automated transaction monitoring, with rule configurations and thresholds set on the basis of the risk-based approach and the assessment of inherent risk;
- increased intensity of CDD measures, specifically with regards to the veracity of required verification measures;
- increased review periods of client information;
- the utilisations of more or higher quality sources for the vetting of information;
- senior management involvement in decision-making, specifically including decisions to on-board high risk clients or to terminate existing client relationships;
- dedicated specialist staff, managing enhanced due diligence or similar high risk processes;
- limited reliance on another accountable institution's controls, together with additional controls to further mitigate inherent risk;
- increased frequency and intensity of staff training; and
- increased compliance monitoring or audit requirements.

Ultimately the AML/CFT controls that are adopted and implemented must be commensurate to the assessed risks and the extent to which risk mitigation is required.

3.3 Assessing residual risks against set risk appetite and risk capacity

Residual risk is the level of risk that remains after controls and mitigation measures have been implemented. The assessment of residual risk is required to determine whether the risks that remain are acceptable to the accountable institution. The acceptability of residual risk should be assessed in terms of (1) the accountable institution's risk appetite statement, (2) risk capacity and (3) risk appetite. These concepts can be defined as follows:[39]

[38] See par 4 2 below in this regard.
[39] Financial Stability Board "Principles for An Effective Risk Appetite Framework" (2013) 2-3.

- *Risk appetite statement*: The articulation in written form of the aggregated level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives.
- *Risk capacity*: The maximum level of risk that a financial institution can assume, given its current level of resources, before breaching constraints determined by regulatory capital, the operational environment (e.g. technical infrastructure, risk management capabilities, expertise) and obligations to depositors, policyholders, shareholders, clients, regulators, and other stakeholders.
- *Risk appetite*: The aggregate level and type of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan.

Where the level of residual risk falls outside of the scope of acceptable risk, additional controls and measures must be adopted to mitigate the risk to an acceptable level.

3.4 Reviewing the risk-based approach

The risk-based approach implemented by an accountable institution should be subject to periodic review, to test the effectiveness of the compliance regime. This review includes, but is not limited to, the following:

i. Applicable policies and procedures;
ii. the risk assessment related to ML/TF risk, including the adequacy of controls and other risk mitigation measures; and
iii. the training program used for employees and senior management.

It is important to note that the implementation of risk mitigation controls and measures could also introduce *emergent risk – i.e.* risk that materialises due to the implementation of the control. Examples of emergent risk include the use of technology for risk mitigation, which could, for example, introduce cyber-security or similar risks, or the use of third-party data providers when verifying client information, which could, for example, introduce privacy concerns. The management and mitigation of emergent risk is an important component of the on-going review of the risk-based approach and the way in which an accountable institution applies this approach.

4 *Impact of a risk-based approach*

Although the application of a risk-based approach has clear implications for the management of ML/TF risk across the business of an accountable institution, the impact of the risk-based approach is primarily aimed at two sets of requirements, as contained in FICA.

4.1 Design of a Risk Management & Compliance Programme (RMCP)

The first set of requirements is now contained in section 42 of FICA and relates to the development, documenting, maintaining and implementing of a programme for anti-money laundering (AML) and the counter financing of

terrorism (CFT) risk management and compliance. Such a Risk Management and Compliance Programme (RMCP) should document how an accountable institution applies a risk-based approach (RBA), complies with the requirements contained in FICA, and effectively manages its ML/TF risk.

The RMCP can be described as the foundation of an accountable institution's compliance with the requirements and obligations contained in FICA, as well as its risk management controls and measures. An RMCP therefore constitutes a collection of documents, including all policies, procedures, processes, controls and systems used for AML/CFT risk management and compliance purposes.

An RMCP should at a high level accomplish the following:

- The RMCP should better enable an accountable institution to effectively apply a risk-based approach and meet minimum regulatory requirements. The objective of an RMCP is therefore to enable an accountable institution to identify, assess, monitor, mitigate and manage ML/TF risk – both through compliance and active risk management.[40]
- An RMCP should furthermore include the development of methods to manage and mitigate the risk that the provision of products or services may involve or facilitate money laundering activities, or the financing of terrorist and related activities.
- An RMCP should address the threats and vulnerabilities that may lead to an accountable institution being unable to detect the abuse of its platforms, products or services for ML/TF purposes.
- An RMCP should include policies, procedures and processes that inform the board and senior management of all AML/CFT initiatives, deficiencies and corrective action taken.
- The RMCP and should establish various committees and oversight bodies to govern, oversee and direct an accountable institution's efforts in relation to the effective implementation of an RMCP.

Based on the above, it is clear that the development of an RMCP cannot be done in isolation of the risk-based approach – the scope and content of the RMCP is inherently and intrinsically informed by the application of a risk-based approach. This is further confirmed by the fact that the board of directors, senior management or other person or group of persons exercising the highest level of authority in an accountable institution must approve the Risk Management and Compliance Programme of the institution.[41]

4.2 Scope of client due diligence (CDD)

The second set of requirements relate to client due diligence – *i.e.* the requirements and measures aimed at ensuring that an accountable institution knows and understands who its clients are.[42] This knowledge should enable the accountable

[40] s 42(2)(a).
[41] s 42(2B), read with s 42A.
[42] See s 21-21H of FICA, as amended.

institution to identify behaviour or transactional activity that does not align to the accountable institution's knowledge of that client, and that could therefore be indicative of money laundering, terrorism financing or related forms of financial crime.

Instead of relying on rigid requirements in regulations and exemptions, the application of a risk-based approach now enables accountable institutions to exercise a greater discretion in determining the appropriate due diligence requirements to meet these objectives.[43] Such requirements could relate to the following aspects of CDD:

- The risk-based approach can inform the scope and nature of information required to *inter alia* establish the identity of a client,[44] the nature and purpose of the business relationship;[45] and the client's source of funds.[46] In this regard, Guidance Note 7 draws a distinction between *basic* identifying information (the person's full names; date of birth; and, in most cases, a unique identifying number issued by a government source) and *supplementary information* (e.g. physical appearance or other biometric information; place of birth; family circumstances; place of employment or business; residential address; contact particulars; and contacts with the authorities or with other accountable institutions.).[47]Although it is expected that the basic attributes will always be used in accountable institutions' processes to establish a client's identity, the accountable institutions has a much larger discretion in determining what supplementary information would be relevant, appropriate and ultimately useful, on the basis of the risk-based approach.[48]
- Secondly, the risk-based approach can inform which information must be verified, as well as the appropriate verification mechanisms that should be applied.[49] Although verification methods are mostly dictated by the type of information used to establish a person's identity in a given scenario, there are a myriad of different verification methods that can now be considered – specifically including the use of third party data providers or data aggregators. The risk-based approach therefore affords accountable institutions the flexibility to use a range of mechanisms to establish and verify the identities of its clients, creating opportunities to explore more innovative ways of offering financial services to a broader range of clients and bringing previously excluded sectors of society into the formal economy. This also improves the efficacy of measures to combat ML/TF, while promoting financial inclusion without undermining AML/CFT objectives.[50]

[43] In general, financial institutions apply three standards of due diligence: simplified due diligence (SDD), standard due diligence (CDD) and enhanced due diligence (EDD).
[44] s 21.
[45] s 21A.
[46] s 21A.
[47] Guidance Note 7 par 86-87.
[48] See Guidance Note 7 par 87.
[49] See Guidance Note 7 par 88.
[50] Guidance Note 7 par 31.

- The appropriate level of management approval / acceptance required to establish or continue with a business relationship.
- The appropriate level of monitoring (transactions and activities) as part of on-going due diligence.[51]
- The appropriate level and frequency of CDD refresh applied, in order to ensure that client information is accurate, up-to-date and relevant.[52]

In accordance with the risk based approach – and specifically the client relationship risk assessment performed as part of this approach – the risk rating of a client can now inform and determine the processes and controls applicable to a client, or class of clients, which are proportionate to the level of ML/TF risk presented by each client relationship.

5 *Conclusion*

Although the various amendments to FICA have only come into effect recently, it is already abundantly clear that the introduction of the risk-based approach into the South African AML/CFT regulatory framework will have significant implications for the management of ML/TF risk and compliance with the requirements of FICA.

It is therefore incumbent on accountable institutions to design and implement risk-based approaches that are geared towards truly understanding their clients, their relationships with their clients, the risk inherent in these relationships, and ultimately the risks faced by their business as a whole. This assessment of risk must be supported by robust risk management and mitigation controls and measures – specifically including well-designed and appropriate client due diligence standards and procedures. These compliance controls can furthermore no longer be regarded as simple tick-box exercises. Although the risk-based approach still requires compliance with all minimum regulatory requirements, the requirement that accountable institutions must make risk-informed decisions through the clear application of mind is now at least as important as formal compliance.

Ultimately, the risk-based approach will enable accountable institutions to utilise new, innovative and bespoke solution to manage and mitigate risk and to make more effective, relevant and appropriate risk-based decisions.

[51] s 21C.
[52] s 21C.

Closing bank accounts: recent developments

SF DU TOIT[*]

1 *Introduction*

Banks, bank accounts and high-profile clients have enjoyed substantial media coverage in recent times. This paper will examine how judgments from November last year to just a few weeks ago dealt with the circumstances under which a bank may close an account, and to what extent these cases applied the legal principles laid down in *Bredenkamp v Standard Bank of South Africa Ltd*.[1] The paper will start with a brief examination of the common-law principles, move on to consider the meaning of "reasonable notice", then deal with the provisions of the Code of Banking Practice and, finally, take a look at the *Bredenkamp* principles. Regardless of actual or perceived interference, and the wider political context, banks should – and do – still base decisions regarding the closing of bank accounts on sound legal principles.

2 *Common-law principles and the notice period*

Like other contracts, the bank and customer contract can be terminated by agreement, or unilaterally by either the bank or the customer.[2] A bank must give reasonable notice of termination,[3] but a customer can terminate the contract summarily. What reasonable notice is, will depend on the circumstances of the case and the nature of the account.[4] In *Prosperity Ltd v Lloyd's Bank Ltd*,[5] dating from 1923, the matter is explained with reference to cheques: a short notice might

* Professor, Department of Mercantile Law, University of Johannesburg.

1 2010 4 SA 468 (SCA).

2 Malan, Pretorius and Du Toit *Malan on Bills of Exchange, Cheques and Promissory Notes in South African Law* (2009) 326; *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] QB 728 756.

3 See *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 (CA) 127; *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785 (HL) 820 ("due notice"); *Volkskas Bpk v Van Aswegen* 1961 1 SA 493 (A) 495-496 ("voorafgaande kennisgewing"); *Prosperity Ltd v Lloyd's Bank Ltd* (1923) 39 TLR 372 37 ("reasonable notice"); *Penderis and Gutman NNO v Liquidators, Short-Term Business, AA Mutual Insurance Association Ltd* 1992 4 SA 836 (A) 842; *Buckingham & Co v London and Midland Bank Ltd* (1895) 12 TLR 70. No distinction should be made between accounts in credit and in debit: *Penderis* 841; *contra Prosperity* 373.

4 *Prosperity* (n 3) 373. The court also refers to "the course of dealing that prevailed between the parties" as important; also *Cumming v Shand* (1860) 5 H&N 95 (157 ER 1114) where the following question was put to the jury: "whether there was, between the plaintiff and the Bank, a course of business which could not be put to an end without a reasonable notice." See also *Thermo King Corp v Provincial Bank of Canada* 1981 CarswellOnt 659 and *Buckingham* (n 3). In the peculiar circumstances of *Prosperity*, there was not an "ordinary banking account", but an "account of a special character" (373). In respect of an overdraft that is payable on demand, "all the creditor has to do is to give the debtor time to get [the money] from some convenient place, not to negotiate a deal which he hopes will produce the money" (*RA Cripps & Son Ltd v Wickenden; Cripps (Pharmaceuticals) Ltd v Wickenden* [1973] 1 WLR 944 955).

5 (n 3) 373; also see *National Westminster Bank* (n 3) 810, 820.

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suffice for a "small" account used by the customer for her own purposes. Longer notice might be required where the customer sends her cheques "to various parts of this country" or "different parts of the Continent". The use of bills of exchange and documents of title may burden the bank with an even longer notice period, according to the court.[6] One month or 30 days[7] might be a good point of departure – but nothing more than that.[8] A similar approach seems to be encouraged in the UK:[9]

> "A firm should not close a customer's account without giving the customer at least 30 days' notice, unless there are exceptional circumstances. These might include a legal obligation to close the account or threatening or abusive behaviour by the customer towards staff."

It is quite conceivable though, that a sophisticated company, might need much more time.[10] It is also possible that the circumstances of the case dictate a shorter period or even immediate closure.[11]

One should further bear in mind, as pointed out by Schulze,[12] that in terms of the contract of mandate between the bank and customer:

> "The duties of a party to the contract of mandate include the duty not to cause damage to the other party. I believe that where a customer of a bank conducts his business in a way which poses operational and business risks to the bank, the latter can validly argue that the mandatory (*ie*, the customer) acts in conflict with this duty …. Such conduct would probably satisfy the test of seriousness and will allow the bank to cancel the contract unilaterally …."

There is thus no need for an express clause allowing termination of the contract,[13] although such a clause is recommended.[14]

[6] It should be noted that in the circumstances of the cases discussed later in this paper, reasonable time cannot be interpreted with reference to the time needed to make alternative banking arrangements: c*f* Malan, Pretorius and Du Toit (n 2) 318 (in the context of an overdraft) and Schulze "The bank's right to cancel the contract between it and its customers unilaterally" 2011 *Obiter* 211 221 (referring to circumstances where the bank would be excused from preventing the customer from becoming unbanked).

[7] Schulze (n 6) 221.

[8] In *Prosperity* (n 3) 374, a month's notice was not considered sufficient.

[9] *Confirmed Industry Guidance for FCA Banking Conduct of Business Sourcebook* (January 2017) s 5.4. A banking customer is defined as a consumer, a micro-enterprise or a charity with annual income less than £1 million (s 1). *Cf* par 3 n 16 below. See Hapgood *Paget's Banking Law* (2007) for a similar period in terms of the former (UK) Banking Code.

[10] See Weerasooria *Banking Law and the Financial System in Australia* (2000) 626: "The larger his or her business, and the wider its operation, the longer the time needed for readjustment."

[11] See Weerasooria (n 10) 628: "There may be special circumstances which may justify the banker in bringing the relationship to an end without notice. For example, where the customer has been operating the account fraudulently or for some other unlawful purpose, the bank may be justified in closing the customer's account immediately or, at most, a purely nominal period of 24 hours' notice would suffice."

[12] (n 6) 220.

[13] In *Bredenkamp* (n 1) par 6 the bank relies on an express term to close accounts with reasonable notice, or alternatively on an implied term with the same effect: an indefinite contractual relationship may be terminated with reasonable notice.

[14] See Schulze (n 6) 220. It is submitted that a tacit term to this effect may be proved, as well as terms implied by law derived from trade usage (see Du Toit "Reflections on the South African Code of Banking Practice" 2014 *TSAR* 568 570-572; Schulze 220).

3 *Code of Banking Practice (2012)*

The Code of Banking Practice contains provisions on closing an account in paragraph 7.3:[15]

> "7.3.1 We will assist you to close an account that you no longer require.
>
> 7.3.2 We will not close your account without giving you reasonable prior notice at the last contact details that you gave us.
>
> 7.3.3 We reserve the right, however, to protect our interests in our discretion, which might include closing your account without giving you notice:
>
> - if we are compelled to do so by law (or by international best practice);
> - if you have not used your account for a significant period of time or
> - if we have reasons to believe that your account is being used for any illegal purposes.
>
> Your bank will inform you about the implications of abandoning an account (not using it) as opposed to closing it. For instance, there may be unclaimed balances with associated fees, balances may have to be written off and you need to know what the reclaim process is, if it applies to your account."

The Code is unlikely to apply[16] to all the persons or entities involved in the cases discussed in the subsequent paragraphs, but these provisions are nevertheless a good indication of current banking practice. In particular, the instances where an account may be closed without giving notice may be relevant in the decisions discussed subsequently, namely: "if we are compelled to do so by law (or by international best practice)" and "if we have reason to believe that your account is being used for fraudulent purposes."

4 *The Bredenkamp*[17] *principles*

The *Bredenkamp* decisions[18] have been discussed before, but as subsequent cases followed the SCA decision, it is worthwhile to consider the principles again. Standard Bank decided to close the accounts for three reasons: the listing of Bredenkamp (and other applicants) as "specially designated nationals"; the risk to Standard Bank's reputation; and the business risks for Standard Bank.[19] As such the court did not consider in any detail domestic and international obligations of the bank flowing from the regulatory environment it found itself in.[20]

[15] *Breedenkamp v Standard Bank of South Africa Ltd* 2009 5 SA 304 (GSJ) par 24-25 refers briefly to the previous version of the Code.

[16] See Du Toit (n 14) 574: the Code applies to personal and small business customers.

[17] *Bredenkamp* (n 1), discussed by Rautenbach "Constitution and contract: the application of the Bill of Rights to contractual clauses and their enforcement" 2011 *THRHR* 510; Schulze (n 6).

[18] See *Breedenkamp v Standard Bank of South Africa Ltd* 2009 5 SA 304 (GSJ) and *Breedenkamp v Standard Bank of South Africa Ltd* 2009 6 SA 277 (GSJ) discussed by Rautenbach "Cancellation clauses in bank-customer contracts and the Bill of Rights" 2010 *TSAR* 637.

[19] Schulze (n 6) 212. See *Bredenkamp* (n 1) par 17-18.

[20] But see *Breedenkamp* (GSJ) (n 16) par 49-50, where brief reference is made to standards imposed in terms of banking supervision, and acts such as the Financial Intelligence Centre Act (FICA) 38 of 2001.

In the *Bank of Baroda* decision,[21] Fabricius J set out seven principles laid down in *Bredenkamp*:

> "1. A bank has a right to terminate a contract with its clients on the notice periods specified in their particular contract. In the absence of an express termination clause, a bank is entitled to terminate on reasonable notice."

This is in accordance with the common-law position.[22]

> "2. A bank has no obligation to give reasons for terminating this relationship. Its motives for terminating such are generally irrelevant (there may be an exception where there is an abuse of rights)".[23]

As indicated by Schulze, however, an absence of reasons may be indicative of an absence of *bona fides*, or even the abuse of rights.[24] It seems that in most cases the banks do (eventually) provide reasons.

> "3. There are no self-standing rights to reasonableness, fairness or goodwill in the law of contract".

It is quite possible that last word on this has not been spoken yet,[25] but even so, it is unlikely that the outcomes in *Bredenkamp*[26] or in any of the cases discussed below, will be influenced.

> "4. Even if there were [self-standing rights to reasonableness, fairness or goodwill] however, it would be fair for a bank to exercise its contractual right to terminate its relationship with its clients on proper notice".

In support of this principle the court quoted the following passage from *Bredenkamp*:[27]

> "The fact that the appellants as business entities are entitled to banking facilities may be a commercial consideration, but it is difficult to see how someone can insist on opening a banking account with a particular bank and, if there is an account, to insist that the relationship should endure against the will, bona-fide formed, of the bank."

The next principle highlighted by the court was:

> "5. A bank is entitled to terminate its relationship with a client on the basis of reputational and business risks and Courts should be reluctant to second-guess that decision."

Once again, the court relied on *Bredenkamp* as authority, where Harms DP concluded:[28]

> "The appellants' response was, that objectively speaking, the Bank's fears about its reputation and business risks were unjustified. I do not believe it is for a court to assess whether or not a bona fide business decision, which is on the face of it reasonable and rational, was objectively 'wrong' where in the circumstances no public considerations are involved. Fairness has two sides. The appellants approach the matter from their point of view only. That, in my view, is wrong."

21 *Annex Distribution (Pty) Ltd v Bank of Baroda* unreported case no 52590/2017 (GP) (21 September 2017) par 22.
22 See par 2 above.
23 See also *Bredenkamp* (n 1) par 7.
24 Schulze (n 6) 221.
25 See *eg* Rautenbach (n 17) 520 *et seq*; Bhana "Contract law and the Constitution: Bredenkamp v Standard Bank of South Africa Ltd (SCA)" 2014 *SAPL* 508 513 *et seq*.
26 See *Bredenkamp* (n 1) par 53. The court stated earlier (par 30): "The case is about fairness as an overarching principle, and nothing more."
27 par 57.
28 par 65.

The bank must therefore "consider and assess the reasons for its decision" and "apply its mind to the matter",[29] in coming to a *bona fide* decision.

The judge continued:

> "6. Irrespective of whether negative publicity about the client is true, a bank is fully entitled to terminate the relationship with a client that has a bad reputation."

In *Bredenkamp*, the court held:[30]

> "… the bank's cancellation was not premised on the truth of the allegations underlying the listing; it was based on the fact of the listing and the possible reputational and commercial consequences of the listing for the bank."

The last principle set out by the court was:

> "7. The fact that the client may have difficulty finding another bank does not impose any obligation on the bank to retain the client."

In *Bredenkamp*, Harms DP states:[31]

> "I find it difficult to perceive the fairness of imposing on a bank the obligation to retain a client simply because other banks are not likely to accept that entity as a client. The appellants were unable to find a constitutional niche or other public policy consideration justifying their demand."

The following sums up the *Bredenkamp* decision, and the legal principles upon which the judgment was based:[32]

> "The bank had a contract, which is valid, that gave it the right to cancel. It perceived that the listing created reputational and business risks. It assessed those risks at a senior level. It came to a conclusion. It exercised its right to termination in a bona fide manner. It gave the appellants a reasonable time to take their business elsewhere. The termination did not offend any identifiable constitutional value and was not contrary to any other public policy consideration."

These principles were all applied in subsequent cases without much variation.

5 *Hlongwane v ABSA Bank Ltd*[33]

In the *Hlongwane* decision, the applicants brought an application in terms of the Promotion of Access to Information Act[34] against ABSA to make certain records available to the applicants, or first to the court, in the alternative.[35] The applicants were ABSA account holders. ABSA informed the applicants that the bank accounts will be closed. The first six applicants were informed in November 2012; the seventh applicant was only informed later. All the accounts were closed in December 2013.[36] When asked earlier for the reason, ABSA (somewhat cryptically) stated:

[29] Schulze (n 6) 221.
[30] par 61; see also par 14.
[31] par 60.
[32] par 65.
[33] Unreported case no 75782/13 (GP) (10 November 2016).
[34] 2 of 2000 s 78(2)(d)(i) and s 82.
[35] par 1.
[36] par 10-11.

> "Absa in the normal course of its business regularly performs reviews of its underlying businesses, and their related client bases, to analyse their alignment to the organisation's overall strategy. On occasion this analysis suggests that there are clients that we cannot serve optimally. In these instances it is best to stop providing banking services."[37]

A complaint to the Ombudsman for Banking Services alleging the closure was because of "the first applicant's political affiliation and/or profile" was rejected, with the Ombudsman stating that no maladministration on the part of ABSA could be found.[38] In a subsequent request in terms of the Act,[39] ABSA only provided some of the documents requested. The reasons given by ABSA as to why the accounts were closed, are instructive, and include the following:[40] in terms of the Financial Intelligence Centre Act (FICA),[41] ABSA must put in place measures to facilitate the detection and investigation of money laundering; its policies must take into account the risk level of its customers to money laundering; when dealing with high-profile clients its due diligence obligations in terms of FICA are more onerous; the first applicant was identified as a Politically Exposed Person (PEP); the Arms Procurement Commission had requested information about some of the applicants; the first applicant became a high-risk client and exposed the bank to risks relating to money laundering; the bank was prohibited from disclosing to the applicants that they were investigated by the Commission; and the bank could close the accounts on notice in terms of the relevant contracts.[42]

The application was dismissed. The court stated that the applicants did not allude in the affidavits to which rights they seek to exercise or protect.[43] ABSA was entitled to terminate the relationship on proper notice – and "ample notice" had been given.[44] As the applicant had apparently become a PEP,

> "there was not only a commercial but also a reputational risk to [ABSA] in keeping the first applicant and his related entities as clients. [ABSA] has no obligation to retain a client whose monitoring in terms of money laundering measures put in place would be more onerous when compared to the benefit in terms of fees, it would receive from the applicants."[45]

The court furthermore stated that ABSA's *bona fides* could not be questioned – "the overriding reason for the decision was business related and concerns about the risks involved."[46] Lastly the court stated that if ABSA gave the information to the applicants, it would have been in contravention of the prohibition against disclosure in respect of the Commission's investigation, and

37 par 10.
38 par 12.
39 s 53(1).
40 par 16.
41 38 of 2001.
42 See par 17-21 for the applicants' submissions and par 22-26 for the respondents' submissions.
43 par 28. This, according to the court, "is indicative of the fact that the applicants might have been on a fishing expedition to find out circuitously what information the Commission had on them" (par 33).
44 par 29.
45 par 30. It is submitted that the argument relating to fees should not, on its own, justify the closing of accounts – *cf KwaMashu Bakery Ltd v Standard Bank of South Africa Ltd* 1995 1 SA 377 (D) 394-395. See also *Bank of Baroda* (n 21) par 38.
46 par 31.

> "this would have led to the exposure of [ABSA's] processes which are in place with regard to investigating and monitoring money laundering activities of their clients and could have exposed confidential information relating to investigations it had undertaken in this regard."[47]

6 *Minister of Finance v Oakbay Investments (Pty) Ltd*[48] *and Oakbay Investments (Pty) Ltd v The Director of the Financial Intelligence Centre*[49]

The background to this judgment, and the political context within which the judgment was delivered, have been widely reported in the media, and discussion here will mainly focus on matters pertaining to the closing of bank accounts.[50] The background facts are:

> "In December 2015, ABSA gave notice to entities in the Oakbay Group to whom it provided banking services, to terminate their contractual relationship and to close their bank accounts. … Subsequently, the other three banks took similar decisions, effectively unbanking the Oakbay Group. All the banks gave the Oakbay Group notice of termination of their banking relationship prior to closing their bank accounts."[51]

A letter was addressed by the CEO of Oakbay Investments to the Minister of Finance in April 2016 regarding the closure of the bank accounts. This was followed by a meeting between the Minister and executives of the Oakbay Group, and the exchange of further correspondence, *inter alia* with the Governor of the Reserve Bank and the Registrar of Banks.[52]

The court heard two main applications and a parallel application. It prepared one judgment in respect of all the applications.[53] In the first main application the Minister of Finance sought declaratory relief against Oakbay Investments (Pty) Ltd and associated entities,

> "that he is not by law empowered or obliged to intervene in the relationship between [twelve of the] respondents [referred to by the court as the 'Oakbay Group'] on the one hand, and [ABSA, FNB, Standard Bank and Nedbank] on the other hand, regarding the closing of the bank accounts held by the former with the latter."[54]

The banks supported the application,[55] and material placed before the court by the regulatory respondents (the Governor of the South African Reserve Bank, the Registrar of Banks and the Director of the Financial Intelligence Centre (FIC)) supported the relief as well.[56] The court found that the applicant had established the condition precedent for the exercise of the court's discretion.[57]

[47] par 32.
[48] unreported case no 80978/2016 (GP) (18 August 2017).
[49] unreported case no 92027/2016 (GP) (18 August 2017).
[50] For interlocutory issues not discussed here, see par 16 *et seq*.
[51] par 12.
[52] par 13-14, 65-66.
[53] par 1.
[54] par 2.
[55] par 8.
[56] par 9.
[57] "the Court must first be satisfied that the applicant is a person interested in an existing, future or contingent right or obligation" – par 52.1 taken from *Durban City Council v Association of Building* Societies 1942 AD 27 32; par 57.

Regarding the second leg of the inquiry,[58] the court held that the question the Minister wants the court to determine, "has been decided previously"; and is not disputed by the Oakbay Group.[59] There was no need for the declaratory relief:

> "the public policy considerations that the Minister, the banks and regulatory respondents contend are relevant to persuade this court to grant the declaratory relief sought, were in the circumstances of this case, abated by the steadfast refusal of the Minister and the banking regulatory respondents to intervene in the dispute … and by the refusal of the banks to review their decision to close bank accounts of the Oakbay Group. … It is therefore unclear what advantage the Minister … will enjoy from the declaratory relief if granted. … If granted the declaratory relief will only serve to confirm what all the parties are aware of and in agreement with, in so far as the law is concerned."[60]

The Minister of Finance wrote to the Director of the FIC on 26 July 2016, "seeking to be advised whether the banks had reported any suspicious transactions against any entity in the Oakbay Group …", as he considered obtaining a ruling on whether:

> "(a) the Minister of Finance (or the Governor of the Reserve Bank or Registrar of Banks) has the power in law to intervene with banks concerned regarding their closure of the Oakbay accounts held with them, and
>
> (b) a basis exist in fact for the contention that the relevant banks terminated the accounts in question for a reason unrelated to their statutory duties not to have dealings with any entity if a reasonable diligent and vigilant person would suspect that such dealings could directly or indirectly make that bank a party or accessory to contraventions of relevant laws …".[61]

In abandoning question (b) in his declaratory application, the Minister did so without taking the court into his confidence as to why he only pursued question (a)[62] – "[t]hat the Minister opted to abandon his intention to enquire into the propriety of the banks and opted for the declaratory order without laying bare his reasons for doing so, leaves the question about the utility of the declaratory relief hanging."

The Minister of Finance, regulatory respondents and the banks all resisted interference.[63] In respect of the establishment of an Inter-Ministerial Committee that might have intervened in the dispute, the court stated that nothing turns on this: the IMC was never approved, the Minister refused to recognise it and did not participate in it and the banks were not influenced in any way.[64]

The application for declaratory relief was dismissed.

Standard Bank brought a parallel application for declaratory relief, "couched in broader terms",[65] seeking an order whereby

[58] "the Court must decide whether the case is a proper one for the exercise of its discretion" – par 52.2 from *Durban City Council* (n 57) 42.
[59] par 62; also 63-64.
[60] par 79-80.
[61] par 67.
[62] par 68.
[63] par 71.
[64] par 75-76.
[65] par 3.

> "[i]t is declared that no member of the National Executive of Government, including the President and all Members of the Cabinet, acting of their own accord or for and/or on behalf of Cabinet, is empowered to intervene in any manner whatsoever in any decision taken by [Standard Bank] to terminate its banking relationships with Oakbay Investments … and its associated entities."[66]

The application failed because of Standard Bank's failure to join the President and members of the National Executive.[67]

The second main application was brought by entities in the Oakbay Group against the Director of the Financial Intelligence Centre, "for an order compelling the Director of the FIC to disclose to the applicants certain information relating to reports made to the FIC by the applicants' erstwhile bankers."[68] As the court granted the applications to strike out,[69] the application was withdrawn.[70]

7 *Annex Distribution (Pty) Ltd v Bank of Baroda*[71]

In the most recent decision regarding the ongoing tale, the Bank of Baroda notified the applicants in writing – the letters were dated 6 July 2017 – that it would sever ties with them, close their accounts and call up all loans. This deadline was later extended to 30 September 2017.[72] The applicants sought an order that the Bank of Baroda is interdicted and restrained from: de-activating or closing the applicants' bank accounts, or terminating the banker-customer relationship; from demanding that some of the applicants repay their loans; and in any way limiting the way in which the accounts are operated.[73] The applicants further requested a determination regarding a reasonable notice period and the date when the loans should be repaid. Regardless of the form of relief, the "case is based on the allegation that insufficient or unreasonable notice of termination of the relationship with [Bank of Baroda] was given."[74] As the application for the "actual" interim interdict would only be heard in December 2017, this was an application for so-called "interim interim" relief, to provide for the period until December,[75] although the court applied the same requirements as that of an interim interdict.[76]

In respect of the entitlement to reasonable notice, *in casu* about 10 weeks, the applicants argued that, in light of the fact that other major South African banks closed their accounts, "the premature termination of the loan facilities would therefore inflict significant harm".[77] In addition, some applicants' "loan facilities had been reviewed fairly recently and they were therefore entitled to

66 par 86.
67 See par 89-96.
68 par 4. The application was based on s 40(1)(e) of FICA.
69 See par 31-42.
70 par 43-44.
71 n 21.
72 par 3.
73 par 1.
74 par 2, 10.
75 par 1, 4.
76 See par 5-9, 11.
77 par 14.

arrange their business affairs accordingly". The court found that the period of almost three months was "more than reasonable notice".[78]

The applicants' affidavits disclosed triable issues to be considered in December 2017.[79] The court applied *Bredenkamp* in response, but there is a novel submission to be considered: the listing in *Bredenkamp*, according to the applicants, "had an objective quality … in that it appears to have been made against objectively-discernible criteria" and the applicants have not been "publicly stigmatized in a similarly objective process".[80] The court pointed out that an "objective investigation or fact-finding exercise" is not required; the bank does not rely on the truth of the allegations, but on damage to its reputation. It is submitted that one can add that in cases subsequent to *Bredenkamp*, as will be pointed out below, much more is made of the bank's obligations in terms of the regulatory environment it finds itself in – whether by virtue of statute, regulation or international instruments, and this more than makes up for the absence of a listing such as that in *Bredenkamp*, which is no more than a factor to be considered by the bank.

Regarding the applicants' transactional facilities, the court confirmed that where a contract can be terminated by notice, there is no need for a valid commercial reason for such termination.[81]

> "One of the objects of requiring reasonable notice it to allow the receiving party sufficient time within which to regulate its affairs. A *prima facie* notice period is reasonable if a longer notice period would not place the party in a more favourable position in the circumstances. This finding is particularly apposite in the present case inasmuch as the Applicants have stated that all their major banks have closed their account, and that it is unlikely that they would be able to find a willing contractual partner under the circumstances."[82]

In addition, the bank alleged that it provided the applicants with a "more informal notice" that termination is under consideration long before 6 July 2017,[83] including the following "interactions": the bank had refused to open new accounts for the applicants since June 2016; from August 2016 the bank called up loans to reduce its exposure; at the time the bank indicated to the applicants that it intends to sever ties; and over this period the bank recovered about R1.2 billion form the applicants. The termination by other banks and firms of their relationship with the applicants, should also have put them on alert. The court therefore held that the notice period was reasonable.[84]

In an important part of the judgment, the court looked at the "substantial prejudice to the bank" should it not terminate the banking relationships with the applicants. After stating that the bank is not merely a contractual partner in the private-law sphere, it continued:

[78] par 24. This was in respect of the first four applicants' loan facilities.
[79] See par 12.
[80] *Cf* Vivian and Spearman "A call for bank oversight" (https://www.iol.co.za/business-report/opinion/a-call-for-bank-oversight-2019934 (10 May 2016) (visited 3 October 2017)).
[81] par 30.
[82] See par 33 in respect of the bank's branches and employees in South Africa, and the use of a payment agent.
[83] par 30.
[84] par 31. This was in respect of the applicants' transactional facilities.

> "Its conduct and transactions are subject to a number of statutory and other legal duties under domestic, as well as international law. By virtue of its global operations, the bank is subject to a host of international and domestic legal duties to combat money laundering and other unlawful activities. These various instruments impose clear duties on the bank to put in place proper control to identify its clients, manage the risk of financial crimes …, including money laundering, and to report unlawful activities."

In this context the court referred[85] to the bank's primary regulator (the Reserve Bank of India); the Basel Committee on Banking Supervision and the Core Principles for Effective Banking Supervision; the Financial Action Task Force; the Banks Act;[86] the Regulations relating to banks;[87] FICA;[88] and the Money Laundering and Terrorist Financing Control Regulations.[89]

According to the court, given the penalties a bank may face, "the logical means to avoid these risks is to terminate the banking relationship with clients that are deemed to be of unusually high risk".[90] It is submitted that these considerations should form the primary focus when a bank considers closing a bank account. As stated near the end of the judgment,[91] the bank's decision not to open further accounts for entities connected to the Oakbay Group, "was the ultimate result of the *FICA* based risk assessment that had then been performed and the continuous monitoring of the Applicants thereafter."

Lastly the court considered "[t]he controversy surrounding the Gupta family and Applicants", detailing much of what has appeared in the media recently, emphasizing that, in terms of the *Bredenkamp* decision, the bank was not obliged to show, "on any basis whatsoever", that the allegations were true.[92] The bank, in considering the risk to its reputation, referred *inter alia* to the report of the former Public Protector, allegations by investigative journalists and civil society; the *Minister of Finance*[93] decision discussed above, including the banks' affidavits. More substantively, the bank reported 36 suspicious and unusual transactions in a 10-month period by the applicants to the FIC with a value of R4.25 billion, saying that this is an indication that the bank "may inadvertently fail to detect and report on such transactions, which would expose the bank and its employees to severe penalties."[94]

The court held concluded that the application to be heard in December has very little prospect of success:[95]

85 par 34.
86 94 of 1990; see *eg* s 60B.
87 *eg* reg 50.
88 38 of 2002; see *eg* s 29.
89 *eg* reg 21 read with Guidance Note 3A; par 25 of the Guidance Note deals with Politically Exposed Persons.
90 par 37.
91 par 39.
92 par 39.
93 n 48.
94 There is some uncertainty in par 39 as to whether the amount is made up of 36 or 45 transactions, and whether the applicants were involved in 36 or 45 transactions.
95 par 41.

> "Where a contractual party, subject to specific regulatory provisions seeks to act honestly and openly to safeguard its rights, and to uphold the integrity of the relevant financial order, and the other party, on the face of it seeks to undermine and subvert it to its own benefit, the balance of convenience in my view clearly favours the former."

The application was dismissed.

8 *Conclusion*

In a somewhat strange twist of fate, banks have become important actors in the current political landscape, by virtue of controlling, subject to supervision, and within a legal framework, who has access to a bank account.[96] It is submitted that all of the decisions discussed above are correct, and can be justified on purely legal grounds, and the principles laid down should be followed in subsequent cases. The subtle shift in emphasis since *Bredenkamp* in considering the regulatory environment and a bank's obligations in terms of both domestic legislation and regulation, and in light of international guidelines, should be welcomed.

Both the conduct of the banks in the circumstances described above, and the court judgments, should foster the Rule of Law.[97] As the court said in the *Bank of Baroda* case,[98]

"Such decision [to close an account] by a bank would also enhance the integrity of the financial system, support openness rather than subversion and enhance the Rule of Law rather than undermine it." Or, earlier in the *Minister of Finance* decision, when considering actual or perceived interference:[99]

> "The banks also resisted whatever pressure they faced to reverse their decision to terminate their relationship with the Oakbay Group. … They [the banks] were prudent to disassociate from any conduct that would disturb the financial stability of the country. Their conduct ought to boost rather than harm confidence in the South African banking system."

[96] During the course of the judgment Fabricius J also remarked: "Other relevant considerations are that there is no right for asserting an entitlement to banking services as a property right. Freedom of trade as a right only applies to natural persons" (*Bank of Baroda* (n 21) par 28). That may be true, but it is submitted that a "right" to a bank account, whilst easily dismissed in cases like these, deserves further consideration, also within the context of financial inclusion.

[97] *Cf* the remarks of Fabricius J in *Bank of Baroda* (n 21) par 40.

[98] (n 21) par 37.

[99] (n 48) par 71-72.

A snapshot of financial exclusion in South Africa

HERBERT KAWADZA*

1 *Introduction*

The recent discourse around financial sector transformation has been widely applauded as long over-due.[1] Nonetheless, cynics are not persuaded. The counter argument is that such agitation was merely sectorial, self-serving by different groups representing their own interests. More specifically it has been ridiculed as a clamour for a narrow form of inclusion, that is: broader market share; enhanced procurement; and increased competition in the highly concentrated financial industry by smaller firms.[2] A defining characteristic of that agenda was the lack of agitation for financial inclusion for the financially illiterate and those whose earnings fall outside certain financial thresholds. This was ultimately a missed opportunity to engender fresh thinking and bring the issue of financial exclusion to fore. Much as the discussion was preceded by mass theoretical and empirical evidence underlining the critical levels of exclusion in the banking services in South Africa,[3] not much in terms of strategies of broadening access to financial services and products by the marginalised groups was covered. On its part government's only decisive response has been the issuance of a series of policy documents restating its intentions to cut the numbers.[4] Such

* PhD (Manchester), LLM (London), PGCE (Manchester), LLB (UZ). Senior Lecturer: Banking and Finance Law, University of the Witwatersrand.

[1] See Parliamentary Monitoring Group "Transformation of the Financial Sector: 14 March public hearings" at https://pmg.org.za/page/Transformation%20of%20the%20Financial%20Sector?via=homepage-feature-card.

[2] See for instance "BMF growls over 'useless' Financial Sector Charter" Fin24 Mar 22 2017; Editorial: "Financial sector needs the heat: The charter did not look at how to grow and diversify the sector" Business Day 08 September 2017.

[3] Eg Wentzel and Diatha "An investigation into factors impacting financial exclusion at the bottom of the pyramid in South Africa" 2016 *Development Southern Africa* 203; Møller *Quality of Life in South Africa* (1997) Social Indicator Research Series; Statistics South Africa *Census 2011 Statistical Release – P0301.4* (2012); Mahajan *Economics of South African Townships: Special Focus on Diepsloot* (World Bank Publications 2014); Nhavira "Whither financial inclusion? A holistic approach" 2015 *Journal of Strategic Studies* 80; Kostov, Arun, Annim, and Adjasi "Voluntary participation and access to finance: a South African view" 2015 *IIMB Management Review* 279.

[4] This is mainly reflected in the National Treasury discussion paper "Treating customers fairly: A draft market conduct policy framework for South Africa" (2014) (available at http://www.treasury.gov.za/public%20comments/FSR2014/Treating%20Customers%20Fairly%20in%20the%20Financial%20Sector%20Draft%20MCP%20Framework%20Amended%20Jan2015%20WithAp6.pdf.) Others also include the Treasury policy document "A financial sector that serves all South Africans" (available at http://www.treasury.gov.za/documents/national%20budget/2017/review/Annexure%20F.pdf).

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pronouncements are yet to translate into tangible reforms.[5] This article seeks to flag the causes and implications of financial exclusion in South Africa. It also proposes policy reforms that could be implemented to deliver banking services at an affordable cost and enable financially excluded households to participate in the formal global economy.

2 *Financial inclusion*

What is meant by financial inclusion is contextual. Its meaning varies widely across global economies.[6] Broadly, however, and within the South African context, it has been synonymous with access to financial services and products from formal institutions. It is narrowly understood to refer to the abolishment of barriers to opening accounts and the immediacy or proximity of banks to the potential user of its services. As such, understanding the depth of inclusion necessitates tallying the total of accounts held within the sector and estimating the ratio of the population with an account.[7]

Sceptics could argue that devoting much attention to the issue of financial inclusion at a time when an alarming number of the population suffers poverty and lack of access to good medical facilities, among other social and economic ills, not only smacks of lack of care on the part of the government but is also immoral. However, that claim could be dismissed for want of understanding of the issue that arises from financial exclusion as well as the crucial role that financial inclusion plays within the economy. Besides being a critical part of the South African government's agenda towards economic empowerment, inclusion has been noted to be necessary for long-term economic growth and poverty reduction.[8] As such, access to banking services is in the long run, a tool to allow the poor and economically disadvantaged to close the poverty gap or reduce income inequality. This in turn contributes to economic growth.[9] In a country

[5] See generally Louis and Chartier "Financial inclusion in South Africa: An integrated framework for financial inclusion of vulnerable communities in South Africa's regulatory system reform" 2017 *Journal of Comparative Urban Law and Policy* 170.

[6] See, for instance, Mehrotra and Yetman "Financial inclusion – issues for central banks" (available at http://www.bis.org/publ/qtrpdf/r_qt1503h.pdf).

[7] See generally Hanning and Jansen "Financial inclusion and financial stability: current policy issues" in Kawai and Prasad (eds) *Financial Market Regulation and Reforms in Emerging Markets* (2011) 284.

[8] Demirgüç-Kunt and Klapper "Measuring financial inclusion: the Global Findex database" 2012 World Bank Policy Research Working Paper no 6025; Dittus and Klein "On harnessing the potential of financial inclusion" 2011 BIS Working Papers no 347; Demirgüç-Kunt and Klapper "Measuring financial inclusion: explaining variation in use of financial services across and within countries" 2013 *Brookings Papers on Economic Activity* 279.

[9] Hannig and Jansen "Financial inclusion and financial stability: current policy issues" *2010 ADBI Working Paper no 259*. Hawkins "Financial access: what has the crisis changed?" *2011 BIS Papers no 56* September 11; Atingi-Ego "Financial inclusion in Africa, monetary policy and financial stability: country experiences" presentation to the Association of African Central Banks, Assembly of Governors' Meeting, Balaclava 23 August 2013.

where economic inequality ranks as one of the highest in the world[10] and where such inequality has been the source of instability and agitation,[11] a step towards financial inclusion could go a long way in generating positive spin-offs and in improving the volatile environment.

Notably, inclusion would help "more consumers to smooth their consumption over time. This could potentially influence basic monetary policy choices, including which price index to target. Secondly, it encourages consumers to move their savings away from physical assets and cash into deposits. This may have implications for monetary policy operations and the role of intermediate policy targets."[12]

Furthermore, recent research provides evidence to support the widely-held belief that inclusion has profound implications for the attainment of monetary and financial stability. It has been shown that the greater the ratio of financial inclusion the more efficient the behaviour of firms and consumers becomes. This in turn impacts on the efficacy of monetary policy.[13] This is illustrated by the fact that broader inclusion usually facilitates central banks' efforts to maintain price stability. Likewise it is argued that financial stability could be engendered by a broader base of depositors and the resultant diversified lending.

Equally important is the fact that financial inclusion also can be used as a policy tool especially in relation to interest rates. It is argued that in an environment characterized by high financial exclusion

> "a large share of the money stock is typically accounted for by currency in circulation, with many households saving in cash "under the mattress". As inclusion increases, a growing share of broad money is likely to be made up of interest bearing bank deposits… Given that the rewards for saving (and the cost of borrowing) are affected by interest rates, greater financial access implies that a bigger share of economic activity comes under the sway of interest rates, making them a more potent tool for policymakers."[14]

[10] See, for instance, *Business Day* "SA's rich-poor gap is far worse than feared, says Oxfam inequality report" (16 January 2017); *Mail and Guardian* "Figures suggest SA has the highest concentration of wealth in the hands of a few" (4 Aug 2016); Leibbrandt, Wegner and Finn "The policies for reducing income inequality and poverty in South Africa" Southern Africa Labour and Development Research Unit UCT, 2011 (available at http://opensaldru.uct.ac.za/bitstream/handle/11090/79/2011_64.pdf?sequence=1); ENCA "South Africa needs to fix its dangerously wide wealth gap" at http://www.enca.com/opinion/south-africa-needs-to-fix-its-dangerously-wide-wealth-gap#; Hoogeveenand and Özler "Poverty and inequality in post-Apartheid South Africa: 1995-2000" in Bhorat and Kanbur (eds) *Poverty and Policy in Post-Apartheid South Africa* (2006).

[11] Bhorat, Hirsch, Kanbur, Ncube *The Oxford Companion to the Economics of South Africa* (2014); Aron, Kahn, Kingdon *South African Economic Policy under Democracy* (2009); OECD "OECD Economic Surveys: South Africa 2015" (at http://www.treasury.gov.za/publications/other/OECD%20Economic%20Surveys%20South%20Africa%202015.pdf).

[12] Mehrotra and Yetman "Financial inclusion – issues for central banks" 2015 *BIS Quarterly Review* 83 88. See also Bilbiie "Limited asset market participation, monetary policy and (inverted) aggregate demand logic" 2008 *Journal of Economic Theory* 162.

[13] See, for instance, Demirguc-Kunt and Klapper "Measuring financial inclusion: The global findex database" Policy Research Working Paper no 6025 World Bank (2012); Atingi-Ego (n 9); Mehrotra and Yetman (n 12) 83.

[14] Mehrotra and Yetman (n 12) 83. See also Morgan and Pontines "Financial stability and financial inclusion" 2014 *ADBI Working Paper* no 488; Khan "Financial inclusion and financial stability: are they two sides of the same coin?" address at BANCON 2011, Chennai (4 November 2011).

It is clear, therefore, that poverty alleviation and financial stability are linked to financial inclusion.[15] Additionally, improving access to finance and improving the use of financial services have a potential to raise people's welfare. There are therefore diverse social and economic benefits that accrue from a broader participation in the banking sector.

3 *Financial inclusion in South Africa*

In its 2016 survey FinScope concludes that 89% of all adults (38.2 million) in South Africa have some type of formal or informal financial account. The remaining adult population of 11%, representing 4.3 million adults, is financially excluded.[16] For a country with a highly-developed financial infrastructure[17] and one that prides itself as the economic hub of Africa, the percentage of exclusion is staggering. Several challenges at both macro and industry levels account for such a state of affairs. Some of these include the following.

3.1 Know-Your-Client requirements

In terms of Section 21 of the Financial Intelligence Centre Act, 38 of 2001 financial institutions or accountable institutions must identify and verify potential clients and other persons prior to entering into a business relationship or conclude a single transaction with them (the "Know Your Client" (KYC) requirement). Depending on the circumstances institutions are also required to verify the residential or physical address of the prospective customer.[18] Much as these onerous obligations are justifiable in ensuring compliance with measures aimed at deterring financial crime, nonetheless they constitute barriers particularly to those residing in rural communities where government-issued documents are not easily accessible. Equally daunting is the fact that obtaining an identity document is costly.[19]

Often the rural poor have to incur substantial costs to access government institutions that issue the identity documents. Without such documentation adults who would otherwise qualify are virtually financially excluded. Requiring

[15] See also Tambunan "Financial inclusion, financial education, and financial regulation: A story from Indonesia" 2015 *ADBI Working Paper* no 535 (available at http://www.adb.org/publications/financial-inclusion-financial-education-and-financial-regulation-story-indonesia); Demirguc-Kunt and Klapper (n 13); Mehrotra and Yetman (n 12) 83; Atingi-Ego (n 9).

[16] FinMark Trust *Results from FinScope South Africa 2016 Survey on Financial Inclusion* (at https://www.finmark.org.za/results-from-finscope-south-africa-2016-survey-on-financial-inclusion/).

[17] The World Bank "South Africa economic update: Financial inclusion critical for South Africa's poor" (May 2013) (available at http://www.worldbank.org/en/country/southafrica/publication/south-africa-economic-update-financial-inclusion-critical-for-south-africa-s-poor).

[18] Section 4(3) of the Financial Intelligence Centre Regulations in GN 1595 GG 24176 of 20 December 2002. Furthermore, the Financial Intelligence Centre Regulations provide guidance to financial institutions or accountable institutions regarding the terms of information that must be obtained from natural persons resident in South Africa.

[19] Bester, de Koker and Hawthorne "Access to financial services in South Africa: A brief case study of the effect of the implementation of Financial Action Task Force Recommendations" 2004 version 1.3 *Genesis* para 6.1 (available at https://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-financial-services-in-south-africa-a-brief-case-study-of-the-effect-of-the-implementation-of-the-financial-action-task-force-recommendations-2004.pdf).

proof of residence is not always beneficial especially for those who do not reside in formal settlements such as councils and municipalities. Recent research has shown that at least one-third of South African households do not have formal addresses.[20] Likewise the census community survey of 2016 noted that nearly 13 percent of South African households reside in informal dwellings.[21] As such a requirement to produce proof of residence to anyone from that set up would undoubtedly be a barrier to having a bank account.

Also disadvantaged on account of the KYC requirements are the low-income migrant workers and asylum seekers who are usually without identity documents. A more flexible approach that allows documents such as student cards and letters from universities as valid forms of identification for purposes of opening a bank account has proved to be effective in countries such as Malaysia.

3.2 Excessive transactional costs and costly borrowing

A contributory factor to exclusion relates to the transaction costs that come with holding a bank account. The South African banking system is said to charge higher fees than most of it compatriots in the G20.[22] In fact it is stated that South African banking fees are up to four times higher than those of Germany, Australia and India. This is usually justified as emanating from high operating costs and other financial sector compliance requirements. Such punitive fees have a negative impact on the quality of both the account and service that a customer ends up opting for. Unfortunately, the statistics showing the depth of inclusion do not consider the quality of those accounts.[23] Policy makers seem to be content that a large percentage of South Africans hold some form of account with bank. For small businesses, and especially the informally employed, which are under-capitalised, credit has always been the mainstay of their operations.[24]

20 Bester, de Koker and Hawthorne (n 19).

21 Statistics South Africa "Community survey 2016: Statistical release P0301" 60 (available at https://www.google.co.za/?gfe_rd=cr&ei=XEdrWLHjCeOo8wfZ4beABg&gws_rd=ssl#safe=strict&q=stats+sa+community+survey+2016+pdf).

22 Banking Enquiry Report to the Competition Commissioner "Costing and Pricing" Chapter 3 (http://www.compcom.co.za/wp-content/uploads/2015/10/3-Costing-and-Pricing_non-confidential1.pdf); Genesis "An inter-country survey of the relative costs of bank accounts" 14 March 2005; *Task Group Report for National Treasury and the South African Reserve Bank, Competition in South African Banking* (April 2004) 114-115; Solidarity Research Institute "A comparative analysis of personal transactional costs of five South African banks" (2016) (https://navorsing.solidariteit.co.za/wp-content/uploads/sites/19/2016/08/Solidarity-Bank-Charges-Report-2016.pdf); *Moneyweb* "Banks cream it off bounced debit orders" (21 June 2017); *Mail and Guardian* "Call for transparency on South Africa's transaction fees" (24 May 2012).

23 See Greve "Quality, not quantity, of financial inclusion key – report" (http://www.engineeringnews.co.za/article/quality-not-quantity-of-financial-inclusion-key-report-2015-11-10/rep_id:4136); *Moneyweb* "The quality of financial inclusion – FinScope SA 2014 Consumer Survey" (4 November 2014).

24 Turner *Information Sharing and SMME Financing in South Africa: A Survey of the Landscape* (2008); FinMark Trust "Financial Access and SME Size in South Africa" (http://www.finmark.org.za/wp-content/uploads/2016/01/Rep_Financial-Access-and-SME-Size-in-SA_Dec2015-1.pdf); Timm "How South Africa can boost support to small businesses: Lessons from Brazil and India" 2011 *Trade and Industrial Policy Strategies (TIPS)*; Kauffman "Financing SMEs in Africa" *Policy Insights No , African Economic Outlook 2004/2005* ADB and OECD (www.oecd.org/dev/aeo).

Unfortunately, due to impediments such as the requirement for collateral, credit is not always readily accessible.[25] The same applies to low income earners and the informally employed may be deterred by the daunting loan-application paper work. Faced with such challenges, the excluded end up being caught in the web of indebtedness[26] as they are bound to make use of the alternative services of informal and unregulated money lenders who charge excessive interest rates and employ predatory lending and debt-recovery tactics.[27]

3.3 Government policy

Until recently, government seemed to find it convenient to leave the private financial institutions and customers to engage on their own.[28] In an era of financial sector liberalisation this is clearly understandable. The issue, however, has been the fact that banks have not always found rural areas profitable for their operations.[29] On its part government[30] has arguably not done much to close the gap either through, for instance, efficient post office facilities, or by providing incentives to the private sector to penetrate such areas. Poor market linkages and low financial literacy (which impacts on the demand for financial products), have been constraining factors for the outreach of the banking sector and therefore, of financial inclusion.[31]

4 *The way forward*

The importance of banking can never be overstated. Unfortunately, over 11 percent of adults are without transaction accounts. As a consequence they are susceptible not only to informal and risky financing alternatives, but are also

[25] See, for instance, Fleisig and Safavian *Reforming Collateral Laws to Expand Access to Finance* (World Bank August 2006).

[26] Deakins, Baldock and Whittam "SMEs' access to finance: Is there still a debt finance gap?" (2008) Institute for Small Business & Entrepreneurship Belfast N. Ireland; Quartey "Issues in SME Development in Ghana and South Africa" 2010 *International Research Journal of Finance and Economics* (Issue 39 - http://www.eurojournals.com/irjfe_39_15.pdf).

[27] National Treasury discussion paper (n 4) "Treating customers fairly"; Mas "Using broadband to enhance financial inclusion" (2016) (available at http://www20.iadb.org/intal/catalogo/PE/2016/15964.pdf); Committee on Financial Sector Reforms "A hundred small steps: Report of the Committee on Financial Sector Reforms" (2009).

[28] The lessons learned from the recent global financial crisis have culminated in the government taking a more proactive approach to the regulation and supervision of financial institutions. Policy documents, particularly by the National Treasury, point to a firmer approach to regulation. See, eg, the National Treasury discussion paper (n 4) "Treating customers fairly".

[29] Triki and Faye "Financial Inclusion in Africa" (2013) African Development Bank (available at https://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/Financial_Inclusion_in_Africa.pdf).

[30] Standard Chartered Bank Special Report "Financial inclusion: Reaching the unbanked" (4 September 2014) (available at https://www.sc.com/en/resources/global-en/pdf/Research/Financial_Inclusion__Reaching_the_unbanked_04_09_14.pdf); Aggarwal and Klapper "Designing government policies to expand financial inclusion: Evidence from around the world" University of California and Development Research Group World Bank (September 2013).

[31] See, for instance, CGAP 2012 "Financial inclusion and the linkages to stability, integrity and protection: Insights from the South African experience" (available at www.cgap.org/sites/default/files/I-SIP%20Report_1.pdf); Louis and Chartier (n 5) 170.

vulnerable to economic shocks.[32] There are, therefore, several issues that need to be sorted out.

A starting point would be a new consensus that contextualises financial inclusion to suit the South African milieu. The current narrow policy characterisation – which defines financial inclusion in terms of access to a bank account - distorts, trivializes and obfuscates the issues by focusing on a single variable and excluding other factors. More specifically, such a portrayal fails to take into account other proxies for financial exclusion. Financial inclusion should not just be about access and proximity to banks. Rather, the quality of the financial product as well as the service offered should also be factored in. This would be premised on, *inter alia*, the customer's experience regarding service and products. So doing, it would be possible to "gauge the nature and depth of the relationship between the financial service provider and the consumer as well as the choices available and the consumers' levels of understanding of those choices and their implications".[33]

What government needs to realise is the fact that people need *banking* rather than, necessarily, *banks* today.[34] There is therefore need to reshape banking not only through regulation but also by way of new paradigms that encourage new banking models. These include embracing inexpensive and innovative technologies through which transactions that were traditionally accomplished through banks can now be undertaken online.[35] Such a proactive response would not only be responsive to demographic and behavioural changes in the new generation of customers, as well as new trends in banking, but also culminate in new market participants. In essence, therefore, the task of attaining financial inclusion should not be relegated to the private banking sector alone.

Furthermore, such usage and satisfaction need to be monitored regularly through demand side surveys. This is critical, especially in the current environment where the churning out of new financial products in the sector is of the order of the day. Failure to do so could result in customer complacency, and, eventually, a plateau in the uptake of banking services. To keep customers informed, government needs to step up its consumer education policies. This view is in line with the understanding that there is a link between financial education and financial inclusion,[36] and that financial education can serve as an instrument for

[32] See Hanning and Jansen (n 7) 284.

[33] Hanning and Jansen (n 7) 289; Demirguc-Kunt and Klapper (n 13).

[34] See Gandhi "New paradigm in banking: banking is necessary, not banks - really?" Bank for International Settlements (2016) (available at http://www.bis.org/review/r160822b.htm); Diekhöner *The Trust Economy: Building Strong Networks and Realising Exponential Value in the Digital Age* (2017).

[35] G20 Financial Inclusion Experts Group "Innovative financial inclusion' – Principles and report on innovative financial inclusion from the access through innovation" Sub-Group of the G20 Financial Inclusion Experts Group (May 2010).

[36] See, for instance, CGAP 2012 "Financial inclusion and the linkages to stability, integrity and protection: Insights from the South African experience" (at www.cgap.org/sites/default/files/I-SIP%20Report_1.pdf). See also Tambunan (n 15); Woldie and Thomas *Financial Entrepreneurship for Economic Growth in Emerging Nations* (2017); World Bank and International Finance Corporation "Enterprise surveys: Indonesia country profile 2009" (2010); Atkinson and Messy "Promoting financial inclusion through financial education: OECD/INFE Evidence, Policies and Practice" *OECD Working Papers on Finance, Insurance and Private Pensions* no 34 (2013) (available at http://dx.doi.org/10.1787/5k3xz6m88smp-en).

inclusion.[37] Potential customers who are armed with financial knowledge would be better placed to select the appropriate financial product from an informed perspective. It is suggested that this would go a long way towards the attainment of government's inclusive economic development agenda.

It is not in doubt that the South African government regards the issue of financial inclusion for low income households as critical. [38] In practical terms however, it is not clear how its policy proposals are to be accomplished. So far the only low hanging fruit has been financial literacy, and, fortunately, government seems to be making much progress in this area.[39] In addition to regulating and supervising the banking sector, government should, through collaboration and partnerships tap into the expertise that the private financial institutions have gathered over the years to craft policy that would work towards the attainment of financial inclusion.[40] Likewise, the regulators need to relax the requirements for the opening of bank accounts by those currently excluded, and facilitate the availability of simple accounts with fewer functions. Banks should also be encouraged to expand their branch networks. The regulatory environment must support greater inclusion.

5 *Conclusion*

The South African government has embarked upon institutional transformation as part of its inclusive economic agenda. However, recent figures regarding the participation of the South African populace in the financial services sector show distressing statistics of financial exclusion. Several factors account for these figures and it is hoped that the current discourse on the closing of that gap will be supported by concrete initiatives which will assist in removing the existing barriers and closing the exclusion gap.

[37] Anderloni, Braga and Carluccio *New Frontiers in Banking Services: Emerging Needs and Tailored Products for Untapped Markets* (2007); Macchiavello *Microfinance and Financial Inclusion: The Challenge of Regulating Alternative Forms of Finance* (2017); Bell, Gorin and Hogarth "Financial education – Does it work and how do we know? Research findings from a study of financial education among soldiers" 2008 *Community Invest* 15.

[38] See, for instance, the National Treasury policy document (n 4) "A financial sector that serves all South Africans". See also the National Treasury policy document "A safer financial sector to serve South Africa better" (February 2011) (available at http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf).

[39] According to a comprehensive study by the Financial Services Board, South Africa currently has a financial literacy rate of 51%, on a par with a number of developed countries and higher than many contemporary developing nations: *Fin24* "Improve your financial literacy in 2017" (15 Jan 2017).

[40] Khan "Issues and challenges in financial inclusion: Policies, partnerships, processes & products" Keynote address RBI (June 2012).

Current issues in the law relating to independent guarantees, performance bonds payable on demand, and standby letters of credit – perspectives from the United States, Australia, Singapore and Canada

KARL MARXEN*

1 *Introduction*

This article presents recent judgments[1] from four different jurisdictions (United States, Australia, Singapore and Canada) in which independent guarantees or performance bonds, payable on demand, featured prominently.[2] Because standby letters of credit, especially popular in North America and with North American banks and companies, largely[3] fulfill the same functions and follow the same principles as independent guarantees and performance bonds, this article refers to several cases in which such standby disputes were litigated, too.

Although foreign cases are not precedents for courts in South Africa, they may be referred to in litigation for their persuasive value. In fact, around the world the law relating to independent guarantees is shaped considerably by lex mercatoria, international practice rules, and convincing landmark cases from domestic or foreign courts. Given South Africa's history which led, inter alia, to the creation of its modern "mixed" legal system, and its general openness to sound legal arguments from foreign jurisdictions in areas where no South Africa law exists or where the "internationality" of the subject matter encourages this approach, this is probably an even more apt observation.[4]

* LLM (Stell), LLD (UJ); Director of Research at the Institute of International Banking Law and Practice (IIBLP), USA. The views and opinions expressed in this article are the author's own and do not necessarily reflect the views and opinions of the IIBLP.

1 Certain facts and developments of the cases discussed in this article were simplified to allow focusing on the main aspects relevant for the analysis.

2 Independent (demand) guarantees go by many names, and the cases presented below, therefore, deal with "bank guarantees", "performance bonds", or "guarantees payable on demand". Irrespective of the terminology employed, the documentary and independent nature of the undertakings are the decisive factors which merit their inclusion in this article.

3 One of the significant differences in practice is that standby letters of credit are not only used in "default situations" but also as so-called "direct pay" undertakings, payable not only upon documents pointing towards default in the underlying transaction, but as a means of settling regular instalments, premiums, interest accrued from the underlying transaction, or other financial obligations.

4 See, for example, Hugo "Bank Guarantees" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 437, 438 with reference to the fact that South African law on independent guarantees has often relied on English cases.

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Two principles play an important role in independent undertakings: the principle of documentary or strict compliance (which is explored in the first two cases from the United States dealing with the requirement that the original standby document must be presented by the beneficiary), and the principle of independence. The principle of independence, and possible exceptions to it, are investigated with reference to cases dealing with arbitration clauses, the need for certification of construction claims, alleged unconscionable conduct of the beneficiary, and breach of negative stipulations contained in the underlying contract.

2 *Doctrine of documentary or strict compliance: the original standby document*

Two recent US-American cases dealt with the provision in a standby letter of credit that required the beneficiary to present the original standby instrument, among other documents, when making a drawing. This concerns the doctrine of strict compliance, according to which the beneficiary must tender documents which comply, on their face, with the requirements of the instrument.[5] If the beneficiary is unable to provide all required documents to the issuer or guarantor, the call on the undertaking fails and payment can be refused due to non-compliance of the presentation.

2.1 *Arch Specialty Insurance Company v First Community Bank of Eastern Arkansas*

In *Arch Specialty Insurance Company v First Community Bank of Eastern Arkansas*,[6] the beneficiary (Arch Specialty Insurance Company) sued the issuer (First Community Bank) of the standby for wrongful dishonour, after the issuer had rejected the beneficiary's presentation as non-compliant. The terms of the standby provided that in order to draw on it, the beneficiary had to submit two documents: a sight draft and the original standby letter of credit. In its first attempt (December 2014), the beneficiary presented the draft, but only a copy of the standby undertaking. It offered to surrender the original standby, however, if the bank would promise to honour the demand. In its notice of discrepancy, sent fifteen days after receipt of the documents, the issuer highlighted several discrepancies and refused to honour. The beneficiary's agent approached the issuer again (April 2015), this time submitting the original standby, but no draft. Again, the bank refused based on the argument that "neither presentment strictly complied with the letter's terms: the 2014 attempt lacked the original letter; the 2015 attempt lacked a sight draft".

The beneficiary sued the issuer, and both parties moved for summary judgement. The court rejected the contention by the beneficiary that "even if

[5] For the doctrine of strict compliance in letters of credit and independent guarantees, see Hugo "Payment in and Financing of International Sale Transactions" in Sharrock *The Law of Banking and Payment in South Africa* (2016) 394, 414-422; and Hugo (n 4) 455-458.

[6] District Court for the Eastern District of Arkansas, Jonesboro Division, USA (23 August 2016). As pointed out above, this case was somewhat simplified to focus on the main relevant aspects; for example, the bankruptcy issue was deliberately left unaddressed.

each attempt failed alone, they succeeded together", and sided with the issuer's argument that there is no legal authority[7] in American law for a "three-and-a-half-month-long presentment" to be possible. Moreover, the beneficiary suggested that "strict compliance doesn't mean slavish compliance" and cited authority[8] for this view. Because the cited case concerned, instead of a missing original standby, the "duplicate amendment produced by the bank, supported by an affidavit of authenticity, covering only an expiration date, and which had been superseded by later amendments", the court in Arkansas was able to distinguish the case. Therefore, the drawing(s) under the standby letter of credit were deemed to be discrepant and non-compliant.

However, it was held that the issuer was precluded from asserting the discrepancies and obliged to honour the standby. The issuer had given its notice of dishonour after the first presentation (sight draft, but only a copy of the standby) only fifteen days after receipt of the documents. The applicable law of New York, however, mandates that a notice of discrepancy has to be given by the issuer within "reasonable time", "but not beyond the end of the seventh business day […] after the day of its receipt of documents".[9] If the issuer fails to give such timely notice, it is "precluded from asserting as a basis for dishonor any discrepancy if timely notice is not given".[10] Thus, even though the presentation(s) by the beneficiary to the issuer were discrepant, the bank was precluded from raising this defence.

Another interesting aspect of this case is the fact that *First Community Bank* issued, accidentally, two standbys. In an act that the court described as an "administrative slip-up", the bank first used its own in-house template to execute the standby and delivered it to the beneficiary, after which the bank was asked to use the beneficiary's own form, which differed only immaterially from the first form. The bank did so, and also delivered this second form to the beneficiary. Although it was not raised as an essential problem in the case, the court concluded that the two different standby forms "were two different contracts", and "[t]o have two partially overlapping letters of credit is perhaps unusual […] but it doesn't make the [beneficiary's] form void".

2.2 *MEPT 757 Third Avenue LLC v Sterling National Bank*

In *MEPT 757 Third Avenue LLC v Sterling National Bank*,[11] the beneficiary of a standby letter of credit (MEPT 757) sued the issuer (Sterling National Bank)[12] for payment of a presentation under the instrument. The standby had been

[7] In South Africa, however, there could be such authority: the South African High Court, in the decision *Kristabel Developments (Pty) Ltd v Credit Guarantee Insurance Corporation of Africa Limited* [2015] ZAGPJHC 264 (20 Oct 2015), held that "contemporaneous presentation", as Satchwell J put it (at 39), is not always necessary.

[8] *Ladenburg Thalmann and Co Inc v Signature Bank* [New York App Div 2015].

[9] *New York Uniform Commercial Code* a 5-108(b); omission by me.

[10] *New York Uniform Commercial Code* a 5-108(c).

[11] [2016] Supreme Court New York USA (6 Dec 2016).

[12] In fact, Sterling National Bank had not issued the standby letter of credit itself, but rather its predecessor (Provident Bank) had done so. This point, however, was not at issue in this case.

issued "in connection with rent security" to MEPT 757 who was the landlord in a lease agreement. It required for a compliant presentation, among other documents, the original letter of credit. When MEPT 757 attempted a drawing on the standby, it submitted all necessary documents except the original standby document. Instead, it attached to the other documents it had sent to Sterling National Bank an affidavit by an employee of the beneficiary in which it was stated that the "original Letter of Credit has been lost and diligent, extensive and thorough efforts made to locate it have not been successful". The issuer refused the presentation as non-conforming, and because MEPT 757 could not cure the first presentation and attempt another, it relied on what was presented so far and sued the issuer. The issuer stood by its decision to reject the demand on the standby, and moved for the dismissal of the law suit. The Supreme Court of the State of New York granted summary judgment in favour of the issuer. Ramos J argued in the proceedings that "we all know that strict compliance can mean a little bit less, at least, than compliance with the literal terms. A number of courts have opined that". However, he went on to state that "we have to look at this in the context of the banking community and how important Letters of Credit are to the business community. We want banks to be able to confidently issue Letters of Credit", without having to fear that if a bank honours a presentation containing only the copy of the standby, another person who is in possession of the original instrument may demand payment yet a second time. When the beneficiary offered to indemnify the bank for taking this risk, the judge rejected the offer with a reference to "bank examiners", implying that bank supervision authorities would probably not accept such an indemnification as adequate security for the potentially pending outstanding liability of the bank. Although not doubting the willingness of the beneficiary in this case to make good on the promised indemnification, the court refused to set a precedent of allowing an indemnification to overcome the problem of a missing original standby. Accordingly, the demand on the standby without the original standby letter of credit was ruled to be non-compliant, meaning the issuer had correctly rejected the claim for payment.

2.3 Requiring the original standby document – a risky practice

These two recent cases show, because of the doctrine of strict compliance, how much importance a court can ascribe to the original guarantee instrument.[13] The text of independent guarantees often provide that a beneficiary must tender the original operative instrument with the demand, and any other applicable documents as the case may be, under the guarantee. Such a requirement is sometimes also inserted into a standby letter of credit, just like in the two cases above. Generally, this practice is a risky one for beneficiaries,[14] for at least three reasons.

[13] It must be emphasised, however, that if the terms and conditions of the guarantee or standby do not expressly require the submission of the original instrument, then the beneficiary, ordinarily, does not have to include it in its presentation.

[14] Klein, McNally, and Abrams "Letters of Credit in Lease Transactions: Drafting Tips" 2004 *Annual Survey of Letter of Credit Law and Practice* 102, 104.

First of all, the original independent guarantee or standby document may be lost, destroyed or otherwise unavailable for presentation when a demand is to be made. Independent guarantees and standby letters of credit are often utilised to cover long-term contracts such as complex construction projects, rental agreements or sophisticated credit schemes, meaning that a call on the instrument may only be necessary years or sometimes even decades after issuance. Naturally, the process of correctly filing, archiving and retrieving the "original" document can present difficulties – and prevent complying demands under the guarantee or standby letter of credit as experienced by Arch Specialty Insurance Company or MEPT 757.

Furthermore, the determination as to what constitutes the original instrument can pose serious challenges and disputes.[15] This may be less of a concern for independent guarantees which, typically, are less often advised through an advising bank.[16] In practice, it seems that many independent guarantees are still today executed in paper form by the guarantor, and physically delivered directly to the beneficiary.[17] Standby letters of credit, on the other hand, are more frequently advised.[18] This means that the communication containing the standby undertaking is relayed from the issuer to the advising bank, often via secure SWIFT message. The adviser then informs the beneficiary of the standby and its terms. This communication between adviser and beneficiary, however, may be sent through telefax or email when time is of the essence, for example, because many beneficiaries will not be a member of SWIFT and cannot be reached through this network (hence the involvement of an advising bank in the first place). The telefax or email sent from the advising bank to the beneficiary, or a printout of this, therefore, would probably constitute the "original" standby in such cases – but an issuer may decide to argue this point and delay or refuse payment, which in turn would necessitate that the beneficiary takes legal action to enforce the standby obligation.

Lastly, the requirement to present the original guarantee document when making a demand has encouraged the South African Supreme Court of Appeal in *Nedbank v Procprops*[19] to conclude that only one single demand on the guarantee was permissible.[20] Because of this judicial interpretation, parties are urged to make their intentions clear within the text of the guarantee if they, in fact, wish to permit multiple demands under the instrument. Especially

[15] See, for example, Nartker "Consequences and desirability of requiring presentation of the original operative instrument" June 2015 *Documentary Credit World* 28, 29.

[16] Even though URDG 758 Article 10 makes provision for it.

[17] SWIFT, of course, allows issuance and advice of independent guarantees through its channels (secure MT 7 series messages). However, it is not uncommon for independent guarantees to be issued by non-bank, that is insurance companies, guarantee specialists or other financial services providers – and many of these non-banks may possibly not be SWIFT members.

[18] Or confirmed by a confirmer and then communicated to the beneficiary. This is another difference, because independent guarantees are usually not confirmed (the URDG 758, for example, do not make provision for confirmation), whereas standby letters of credit regularly are (for which the ISP98 contain rules, such as Rule 2.01 and 2.04).

[19] [2013] ZASCA 153 (20 Nov 2013).

[20] Van der Merwe AJA at par 10: "The provision that the demand must be accompanied by the original guarantee strongly indicates that only one payment was envisaged."

if the guarantee is likely to be litigated in South Africa,[21] this point must be considered carefully by the beneficiary when drafting the underlying contract which should prescribe the (exact) wording of the to-be-issued guarantee, and when examining the guarantee text after issuance and delivery to it.[22]

For all these reasons, it is astonishing that both standbys issued by First Community Bank in the Arch Specialty Insurance case contained almost identical terms, despite one of them being based on the beneficiary's own form – which also contained the requirement that the original standby instrument had to be represented in order to make a complying demand. This serves as evidence that not only First Community Bank was probably ill-advised (having effectively exposed itself to potential liability under two standbys due to administrative shortcomings), but also the beneficiary Arch Specialty Insurance Company because including this documentary requirement – in its own form or template – is certainly not advantageous. Although this is only a guess, it is likely that the beneficiary simply resorted to a copy-paste job when compiling its form or template without appreciating this clause and its implication.

3 *The principle of independence in Australia: Negative stipulations and unconscionable conduct*

Australian law relating to independent guarantees and performance bonds has, in the recent past, undergone some important developments regarding the principle of independence and the interpretation of possible exceptions to it. Besides fraud, which is clearly recognised in most jurisdictions (although with local adaptations and interpretations),[23] Australian law has subscribed to the so-called negative stipulation defence, and explored limits to independence based on "unconscionable conduct" by the beneficiary.

3.1 *CPB Contractors Pty Ltd v JKC Australia LNG Pty Ltd*

The *CPB Contractors* v *JKC Australia LNG* litigation series, comprising four judgments,[24] is a recent example of the negative stipulation defence in Australian law. Like in many guarantee cases, it was a construction context that gave rise to the dispute. The four judgments are dealt with below under four subheadings devised from their citations, namely WASC 112, WASCA 85, WASCA 123 and WASCA 132.

(a) *WASC 112*

The Supreme Court of Western Australia was the first court to hear the dispute between CPB Contractors Pty Ltd (referred to here as "CPB") and JKC Australia

[21] For example because of an express forum clause in the independent guarantee, or the application of a 35(a) if the guarantee is subject to URDG 758 and was issued by a South African entity.

[22] See also Avidon "Is it a trap, or a warning to an unwary beneficiary of a letter of credit?" 2010 (Winter issue) *George Mason Journal of International Commercial Law* 1 2.

[23] See Hugo (n 4) 450.

[24] [2017] WASC 112; [2017] WASCA 85; [2017] WASCA 123; and [2017] WASCA 132. Moreover, the parties resorted to arbitration as well.

LNG Pty Ltd (here "JKC") which were engaged in a construction project relating to oil and gas production facilities. JKC was the main contractor to the project, and subcontracted with CPB to execute certain parts of the work. After the two parties concluded the subcontract, CPB had to procure performance bonds (also referred to as "bonds", "bank guarantees", and "first demand guarantee" in the judgments) to secure its performance under this subcontract. On application of CPB, four independent guarantees, payable on demand, were issued by a guarantor in favour of JKC.

The subcontract provided in clause 35 that JKC "may have recourse to the Bank Guarantee(s) at any time in order to recover any amounts that are payable by Subcontractor [CPB] to Contractor [JKC] on demand", and that "Subcontractor [CPB] waives any right that it may have to obtain an injunction or any other remedy or right against any party in respect of Contractor [JKC] having recourse to the Bank Guarantees(s)".[25] Additionally, the contract included a clause for liquidated damages to be paid by CPB to JKC in case it fails to perform in accordance with the milestone and completion dates (clause 36), and provided for dispute resolution methods (clause 57) whereby the parties had to give each other notice in the event of a dispute, attempt to settle it amicably within 35 days and, failing that, resort to arbitration to rule on the matter with finality and binding effect. Despite the arbitration clause being written in a far-reaching and broad fashion, the contract detailed that the parties were not prohibited "from applying to a court to seek urgent relief (including injunction or conservatory measures)".[26]

The subcontract between the parties contained milestone and completion dates in a schedule, which determined what stages of the construction had to be completed at what date, and allowed for time extensions in case of delay due to specific reasons listed in the subcontract. When difficulties and delays were experienced, CPB and JKC agreed on re-scheduling timeframes and payment terms.

After a dispute escalated over requested extensions of time necessary to complete the construction work, JKC demanded payment of AUD 39m in liquidated damages from CPB pursuant to clause 36. Since CPB challenged the amount and refused to pay, it feared a call by JKC on the performance bonds/independent guarantees. By way of precaution, CPB argued that JKC may only make demands under the guarantees once it "has been established that the amount demanded is actually or objectively payable".[27] It also requested written assurance by JKC that it would not call up the bonds/guarantees.

Eventually, CPB gave notice of dispute in accordance with clause 57, and referenced its contention that no call on the performance bonds was allowed. This dispute notice was referred to in the litigation as the "Bond Dispute Notice". JKC argued that the dispute resolution procedure under clause 57 was premature as no call was yet made and, in any event, could not have any effect

[25] par 11 (WASC 112); insertions by me.
[26] par 14 (WASC 112).
[27] par 3 (WASC 112).

on the availability of the bonds/guarantees, as it would otherwise "defeat the very purpose of the security provided under [clause 35]".[28] JKC, essentially, highlighted the independent nature of the bonds/guarantees, which were payable (by the guarantor) on demand.

Shortly thereafter, CPB took to the Supreme Court of Western Australia and sought an "injunction restraining JKC from demanding or receiving any payment"[29] from the guarantor under the bonds/guarantees, until the dispute regarding the time extension was resolved by negotiations or arbitration. It stressed the urgency and importance of the injunction on an ex parte basis due to the fact that JKC could at any moment demand payment under the bonds/guarantees. A temporary interim injunction was granted against JKC,[30] and subsequently CPB applied for an interlocutory injunction, and also an injunction forcing JKC "to comply with the dispute resolution process" prescribed under clause 57 (which mandated negotiation and, if unsuccessful within 35 days, commencement of arbitration).

Amount payable

The court identified two pillars on which CPB tried to build its case: "The first is that the Subcontract which underlies the Bank Guarantees contains an implied negative stipulation that JKC will not demand payment under the Bank Guarantees unless objectively an amount is payable by CPB to JKC on demand. By "objectively payable" CPB means authoritatively established, that is by agreement or determination by an arbitrator or court".[31]

Bond dispute notice

The other pillar was linked to the first one, and rested on the argument "that there is a dispute over the proper construction of [clause 35] of the Subcontract which must be resolved in accordance with the dispute resolution process prescribed in [clause 57] of the Subcontract. The final determination of the proper construction and application of [clause 35] has been committed to arbitration and cannot be determined by this court. If JKC was able to call upon the Bank Guarantees it would be unable to comply with the dispute resolution process",[32] but instead render the whole arbitration proceeding potentially moot. It can be assumed, viewed properly, that CPB's objection based on the "bond dispute notice" was also a defence in the guise of a "negative stipulation".

In response, JKC stressed the existence of the arbitration agreement, too, and argued that if anyone should grant interim or urgent relief, it must be the arbitration panel. Moreover, the "Bonds are intended to operate as a risk allocation device pending the final determination of the dispute between the

[28] par 22 (WASC 122); insertion by me.
[29] par 23 (WASC 112).
[30] par 25 (WASC 112).
[31] par 27 (WASC 112).
[32] par 29 (WASC 112); insertions by me.

parties", so JKC, and clause 35 must not be construed as a "negative stipulation" which could possibly restrict JKC's rights to proceed with a demand under the guarantees.[33]

With reference to the "carve out" provision in the contract,[34] the court decided that the application by CPB was indeed urgent (because a call by JKC on the guarantees was conceivable at any moment) and thus within the scope of the "carve out" provision. Therefore, the court was allowed, in principle, to accommodate CPB's application. The judge analysed the different provisions of clause 35 of the contract, which provided that JKC "may have recourse to the Bank Guarantee(s) at any time in order to recover any amounts that are payable by Subcontractor [CPB] to Contractor [JKC] on demand",[35] and the subsequent provision that the "Subcontractor [CPB] waives any right it may have to obtain an injunction or any other remedy or right against any party in respect of Contractor [JKC] having recourse to the Bank Guarantee(s)".[36] Discussing the question whether the latter stipulation was an impermissible ouster of the court's jurisdiction,[37] the court held that it was, rendering this particular aspect of clause 35 null and void. JKC, accordingly, could not rely on it to argue that CPB had waived its right to apply for court relief.

Nevertheless, the court denied CPB's application for an injunction restraining JKC from demanding or accepting payment related to the guarantees. The decision elaborated on several aspects,[38] including most notably the construction of clause 35 of the contract between contractor and subcontractor which provided that contractor JKC "may have recourse to the Bank Guarantee(s) at any time in order to recover any amounts that are payable by Subcontractor [CPB] to Contractor [JKC] on demand". CPB relied on the words "any amounts that are payable" (contained in the subcontract) and suggested that these words restricted ("conditioned"), as an implied negative stipulation, JKC's right and ability to make drawings under the guarantees. Counsel for CPB argued that a drawing on the guarantee was only allowed "after it has been objectively determined by an arbitration that it is payable, that it has to be objectively the case that the amount is payable, that there needs to be an objective determination of the dispute that exists, it must be agreed that the amount is due and payable or it has to be determined by an arbitrator that it is due and payable, the amount must be objectively determined to be payable or where there is a bona fide dispute whether the amount is payable it is only objectively payable after it has been agreed or there has been a determination at an arbitration. [Counsel] said that the amount must be actually or indisputably payable."[39] This was rejected by the

[33] par 30-31 (WASC 112).
[34] As remarked above, the contract stated that the parties were not prevented "from applying to a court to seek urgent relief (including injunction or conservatory measures)", despite the arbitration clause.
[35] insertions by me.
[36] insertions by me.
[37] par 43-56 (WASC 112).
[38] par 59-84.
[39] par 73 (WASC 112); insertion by me.

court, because CPB had agreed to "provide irrevocable guarantees 'payable on first demand of [JKC]' to guarantee the due performance of [CPB's] obligations under the Subcontract. A first demand guarantee is a guarantee that must be honoured by the guarantor upon the beneficiary's demand. The beneficiary is not required to first make a claim or take any action against the obligor [here: CPB] of the guaranteed obligation that the guarantee supports. It would defeat the purpose of a first demand guarantee if the beneficiary (JKC) is required to establish by an arbitration award or court judgment or by some other means that the amount demanded is 'actually or indisputably' payable before it may make demand on the bank for payment."[40]

Additionally, the court addressed the issue of repayment (or not) in case that a subsequent determination (arbitration award or court decision) after a demand on the guarantee, finds that payment of the guarantee was in fact not justified. Even though the agreements of the parties did not contain express repayment provisions, so the court said, any subsequent adjustment or repayment can be achieved under "general law remedies to recover from Contractor [JKC] any amount demanded under the Bank Guarantee which it was later determined Contractor [JKC] was not entitled to."[41]

Reading the different contract clauses in context, the court came to the conclusion that the bonds/independent guarantees were utilised "to ensure that JKC will have the funds during a dispute between the parties, that is it is an allocation of risk when there is a dispute (risk allocation device)".[42]

Accordingly, the court could not find evidence of a prima facie case in favour of CPB, and dismissed its application for the interlocutory injunction. Furthermore, the judge remarked that even if a prima facie case had been established, the application would have been denied because the balance of convenience test could not be decided in favour of CPB: "The Bank Guarantees are a risk allocation device. CPB agreed to provide to JKC unconditional irrevocable bank guarantees payable on first demand without notice to CPB. The purpose of the Bank Guarantees, and the provisions in the Subcontract relating to them, would be defeated if JKC is restrained from calling on the Bank Guarantees until the dispute concerning extensions of time and liquidated damages has been resolved by arbitration."[43] Hence, the Supreme Court of Western Australia sided with JKC, and denied the injunction requested by CPB to restrain JKC from calling on the bonds/independent guarantees.

(b) *WASCA 85*

The decision of the Supreme Court of Western Australia was appealed, and the Court of Appeal of the Supreme Court of Western Australia, in an order "delivered extemporaneously", ruled "that the appeal has, in the relevant sense,

[40] par 75 (WASC 112); insertions in brackets by me.
[41] par 80 (WASC 112); insertions by me.
[42] par 81 (WASC 112).
[43] par 84 (WASC 112).

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reasonable prospects of success".[44] It also granted the injunction sought by CPB against the beneficiary JKC "pending the determination of the appeal".[45]

(c) *WASCA 123*

In the subsequent proceedings dealing properly with the appeal and its merits,[46] however, CPB's contentions were dismissed. In a comprehensive and meticulous manner, this court listed the content of the relevant clauses of the underlying construction contract.[47]

It laid out the two main grounds upon which CPB attacked the initial decision, namely the issue of the "bond dispute notice", and the question whether recourse to the guarantee was only permissible if the sums demanded were, in terms of the underlying contract, "payable" by CPB to JKC ("amount payable").

Bond dispute notice

CPB raised again the argument that the underlying contract in fact contained an "implied term" which required JKC "to do all things necessary on its part to enable [CPB] to have the benefit of the contractually agreed dispute resolution process in [clause 57] in respect of a dispute over the proper construction of [clause 35] which had been properly committed to that process."[48] A demand on the independent guarantees, therefore, should be interdicted because CPB gave notice of its intention to commit the dispute to arbitration, and any call on the guarantees would undermine this dispute resolution process agreed upon in clause 57. The judges, however, disagreed, and noted: "In our view, the implied duty to cooperate does not sustain the subcontractor's [that is: CPB's] contentions", but rather this "implied duty to cooperate does not rise above the promises made by the parties to the contract. The duty 'cannot override the express provisions of the contract'. A duty to cooperate cannot be imposed on a party so as to compel that party to bring about a circumstance or result which the contract does not require. By [clause 35] the contractor [JKC] has a right against the subcontractor [CPB] to have recourse to the Bank Guarantee(s) at any time. The implied duty of cooperation cannot be extended so as to substantially impair the contractor's express contractual right under [clause 35]."[49]

The judges continued and unequivocally rejected CPB's argument: "On a proper construction of the Subcontract the fact that a party has invoked the contractual dispute resolution procedure in respect of a dispute does not mean that the status quo must be preserved pending resolution of the dispute."[50]

[44] par 1 and 8 (WASCA 85).
[45] par 10 (WASCA 85).
[46] [2017] WASCA 123.
[47] Most relevant were, again, clause 35 (dealing with the guarantee), clause 36 (concerned with liquidated damages), and clause 57 (relating to the dispute resolution procedures).
[48] par 67 (WASCA 123); insertions by me. This issue was, essentially, repeated again at par 76.
[49] par 77 (WASCA 123); my insertions, footnotes omitted.
[50] par 78 (WASCA 123).

Amount payable

Additionally, CPB was still of the opinion that clause 35 in the underlying contract dealing with the bank guarantee contained "an implied negative stipulation that [JKC] will not demand payment under bank guarantees unless an amount is actually, objectively or indisputably payable by [CPB] to [JKC]".[51] CPB awarded great significance to the terms "any amounts that are payable" in the underlying contract, and maintained that this meant that recourse to the independent guarantee was only permitted if moneys were "payable" in line with the underlying construction work and the subcontract, that is "objectively and indisputably" due to JKC.

Giving consideration to the text of the subcontract, the Court of Appeal noted that "[t]he power to have recourse to the bank guarantee for this purpose is a 'right' or 'remedy' given to the contractor", and that this "power is exercisable 'at any time', and is not expressed to be conditional upon an admission of liability by the subcontractor [CPB] or an arbitral determination".[52]

The court then posed what it called the "central question", that is "whether the word 'payable' circumscribes the scope of the power so as to confine its exercise to circumstances where the amount in question is not in dispute, either because of an admission by the subcontractor [CPB] or because of an arbitral determination favourable to the contractor [JKC]."[53]

This was denied with regard to several reasons. For example, the relatively short life-spans of the independent guarantees were an indication to the court that it could not have been the intentions of the parties that first an arbitral tribunal had to rule on the issue of liability before a demand was to be made on the guarantees, as "there would be a real risk that the relevant Bank Guarantee would expire before the question of whether an amount was payable had been determined by the completion of the arbitration process".[54] Moreover, in light of the "at any time" phrase attached to the clause in the underlying contract dealing with the guarantee, it was concluded by the court that "an honest claim" (or bona fide claim) was sufficient to satisfy the "amount payable" requirement, meaning that as long as the beneficiary acted pursuant to an honest belief of entitlement to the sums, it could draw on the guarantee.[55] "Provisions entitling a principal to recourse on the basis of an honest but disputed claim are not uncommon in large construction projects",[56] so that "[i]n our view, [JKC's] self-help remedy of recourse to the Bank Guarantee […] is not affected by [CPB] disputing [JKC's] claim, and need not await admission or subsequent arbitral determination."[57] Accordingly, the court dismissed the appeal, and refused to accommodate CPB's request for an injunction against the beneficiary JKC.

[51] par 67 (WASCA 123); insertions by me.
[52] par 100 (WASCA 123); insertions by me.
[53] par 100 (WASCA 123); insertions by me.
[54] par 106 (WASCA 123).
[55] see par 4, and 117 et seq, especially 123 (WASCA 123).
[56] par 133 (WASCA 123).
[57] par 125 (WASCA 123); insertions by me.

(d) *WASCA 132*

However, the previous injunction against the beneficiary JKC, which had been temporarily granted earlier pending the appeal (which was eventually dismissed in [WASCA 123]), was extended by party consent for another week "to enable CPB to apply for an injunction pending determination of an application by it for special leave to appeal to the High Court". This was divulged in yet another decision handed down by the Court of Appeal,[58] the fourth judgment in this litigation series. In this, so far, last decision from the Court of Appeal the judges had to consider the prospect of special leave to appeal. Determined by the particulars of CPB's application, the relevant criteria for granting special leave were "whether the proceedings in which the judgment to which the application relates was pronounced involve a question of law […] that is of public importance, whether because of its general application or otherwise".[59] Because the court was "not persuaded that CPB's proposed special leave application […] would involve anything more than the application of settled principles of contractual construction to the particular provisions of the Subcontract",[60] it was held that "CPB has not demonstrated that its prospects of a grant of special leave are better than insubstantial. We are not persuaded that CPB's proposed special leave application has substantial prospects of success."[61] After also dismissing the balance of convenience as not being in favour of CPB,[62] the court denied CPB's application for an extraordinary injunction pending an application for special leave, and also the application for special leave itself.[63]

The result of this would have been that CPB lost all its attempts to restrain JKC from calling up the bank guarantees, and the extinction of the temporary injunctions previously obtained. In yet another surprising twist of events,[64] however, in the meantime and again by party consent, "the arbitration tribunal granted an interim injunction until the earlier of its decision or [date in July 2017]." Although CPB has probably exhausted, unsuccessfully, all judicial avenues, the final outcome of the dispute will, quite possibly, remain unknown given that arbitration proceedings are typically subject to confidentiality agreements.

The decisions in this series of litigation largely affirm the concept of independence in performance bonds or bank guarantees payable on demand.[65] Nevertheless, they are also evidence that under Australian law calls on independent guarantees or performance bonds may be restrained were there are violations of so-called "negative stipulations" in the underlying contract.

[58] par 2 (WASCA 132).
[59] see par 19 (WASCA 132); and s 35A(a)(i) Judiciary Act 1903 (Cth).
[60] par 31 (WASCA 132); omission by me.
[61] par 32 (WASCA 132).
[62] see par 34-37 (WASCA 132).
[63] par 39-40 (WASCA 132).
[64] as revealed in par 3 (WASCA 132); insertion by me.
[65] obviously with the exception of the decision in WASCA 85 based on the urgent application by CPB, which prompted the court to granted a temporary injunction pending the outcome of the subsequent proper appeal proceedings.

However, the appeal decisions curbed the attempt to elevate an "amounts payable" clause, in the underlying contract, to be such a "negative stipulation" which necessitates a determination on the underlying contract, before the – independent – guarantee may be called up. The *CPB Contractors* case is not the only instance of such an attempt to test and stretch the boundaries of the "underlying contract"/ "negative stipulation" defence. In fact, in recent years several courts had to deal with contentions, usually advanced by applicants of independent guarantees, that stipulations in the underlying contract relating to "payable", "due and owing", "due and payable" or variations thereof, may have a bearing on the (un)availability of the independent guarantee. In all these cases the applicant, exactly like CPB, would try to motivate the courts to embark on lengthy and awkward investigations of the underlying contract and its provisions, and the eventual question whether it can or should have an effect on the guarantee. Although these tactics may not always work (that is result in an injunction against the beneficiary), they are able to discourage calls on independent guarantees (or lead to party submission to extend or allow injunctions, as was the case here), or at least delay the effective payment of such calls, and generally challenge the utilisation of independent guarantees as efficient risk allocation devices.

Apart from that, the reference in the first judgment [WASC 112] to "general law" as a basis for recovering money (paid out after a fraudulent or otherwise unjustified call on the guarantee), merits attention. Although probably correct in most legal systems, parties are generally well-advised to include express repayment or final accounting clauses into their agreements to avoid problems should the issue be litigated in a court less inclined to resort to "general law".

Lastly, the word "unconditional" was unfortunately used in the judgments to express the independence of the bank guarantees. Independent guarantees and performance bonds are not "unconditional" promises – they require at least a demand (typically in writing) by the beneficiary, and often even more supporting documents. The court was probably inspired to use this inappropriate term by the parties themselves, given that the underlying subcontract mentions "unconditional" and "unconditionally" when referencing the guarantee(s) which the subcontractor CPB had to procure. The Appeal judgments continued to use the term throughout the litigation.

3.2 *H Troon Pty Ltd v Marysville Hotel and Conference Centre*

A dispute relating to a construction contract also gave rise to this Australian judgment,[66] in which the Supreme Court of Victoria ruled on the application for interlocutory and permanent relief by the applicant of an independent guarantee. In this case, the applicant relied on both unconscionable conduct and the breach of a negative stipulation to justify its application for injunctive relief.

H Troon Pty Ltd (referred to as "Troon" in this case analysis) and Marysville Hotel and Conference Centre Pty Ltd (referred to as "Marysville") entered

[66] *H Troon Pty Ltd v Marysville Hotel and Conference Centre* [2017] VSC 470.

into an agreement for the construction of a hotel and conference venue. The contractor Troon had to procure, in favour of Marysville, two independent guarantees to secure its performance under the construction contract. On application of Troon, the Westpac Banking Corporation issued two independent guarantees to Marysville, each for the sum of AUD 750k.[67]

Under the construction agreement, a company called "WT Partnership" was engaged as the "certifying superintendent" (responsible for payment, practical completion, and final completion certificates) to the project (WT Partnership was formally appointed by the Australian State of Victoria), and the company "Metier 3" as the "non-certifying superintendent" to the project, employed directly by Marysville to "provide architectural design services and to act as Superintendent for all matters relevant to that function, except certification".[68]

The envisaged date for practical completion, in the contract originally stated as September 2014, was postponed by party agreement to January 2015,[69] and finally achieved by Troon in February 2015.[70] Having reached this crucial stage in the construction, the first independent guarantee was returned by Marysville and presumably cancelled since it was no longer needed.[71] In February 2016, one year after practical completion and after the "final defects period" of 12 months had lapsed, Troon submitted its "final payment claim" by letter to Metier 3, the non-certifying superintendent, and requested that also the second bank guarantee be returned and cancelled because, in the opinion of Troon, no defects were outstanding and the construction project completed.[72] However, Marysville claims that this letter was sent only to Metier 3 and thus not received by the certifying superintendent (WT Partnership),[73] and that there were "from about the end of 2015 through to at least mid-2017 […] substantial defects and uncompleted work items formally notified under clause 37 of the Contract".[74]

For that reason, no "final certificate" was issued by WT Partnership within 14 days after submission of the "final payment claim", as provided for in the construction contract and, according to Troon, Marysville "did not ensure that the Superintendent acted as required by […] the Contract in relation to the issue of a Final Certificate".[75] Troon argued that "this breach by [Marysville] 'prevented' the issue of the Final Certificate under the contract and enabled [Marysville] to attempt access to the security guarantee or as [Troon] puts it this act of 'prevention' by [Marysville] directly impacted upon the circumstance that [Marysville] is now seeking to make a demand on the Bank Guarantee", amounting to "breach of contract" and even "unconscionable conduct".[76]

67 par 4(g).
68 par 4(d) and (e).
69 par 4(f).
70 par 4(h).
71 par 4(h).
72 par 4(j) and (k).
73 par 4(6) and 25.
74 par 7 and 10; omission by me.
75 par 8-9; omission by me.
76 par 9; insertions by me, footnote and emphasis omitted.

Marysville replied that it asserted a claim against Troon for liquidated damages for the construction delay, and, therefore, had issued an invoice to Troon in which the final payment claim of Troon was considered and then offset against its own claim for liquidated damages.[77] Given that the invoice was issued by Marysville and not the certifying superintendent (WT Partnership), Troon complained, inter alia, that it was unclear whether the invoice really served as a final certificate to which it saw itself entitled to.[78]

Marysville agreed to return the bank guarantee on several conditions, among them evidence or confirmation that previously discovered defects be rectified, test results and certificates relating thereto be submitted, and the liquidated damages claim be paid by Troon.[79] Troon sought to pay the damages claim against the return of the bank guarantee document, but this attempt failed as defects relating to the fire prevention and lighting system had been asserted, prompting Marysville to refuse surrender of the guarantee.[80] Subsequently, Marysville decided to present the guarantee to the issuer, Westpac Banking Corporation, for payment of the entire guaranteed sum of AUD 750k.[81]

Troon was, for the time being, successful and obtained an ex parte urgent interdict preventing Marysville from calling up, or receiving money from, the bank guarantee. The interdict was continued temporarily in a further court order but, in that same court order, Troon was nevertheless directed to pay Marysville the sum of AUD 240k plus taxes, which Marysville had incurred to another contractor to rectify some urgent defects.[82] Troon adhered to this court order and paid the AUD 240k to Marysville and, subsequently and voluntarily, also the liquidated damages claim.

This judgment by the Supreme Court of Victoria discussed here concerned Troon's application to obtain new interlocutory[83] or even permanent relief against Marysville, preventing it from calling up the guarantee indefinitely. Essentially, the central issue was whether Troon was entitled to be issued the final certificate under the construction contract, which would serve as proof that Troon had fulfilled its obligations under the construction project which, in turn, would be a compelling argument for returning the guarantee (or barring calls on it permanently).

The court stated that there is a "serious issue to be resolved ultimately in relation to the multifaceted question of fact and, to some degree, law as to the nature and extent of defective and incomplete work required to be attended to and rectified by [Troon] prior to [Troon] being entitled to the Final Certificate under the Contract and the related question whether, in the circumstances […] the Certifying Superintendent was obliged to issue a Final Certificate under the Contract".[84]

77 par 11.
78 par 12.
79 par 13.
80 par 14-15 and 17-24.
81 par 16 and 27.
82 par 2 and 29.
83 Although not entirely clear from the judgment discussed here, it seems that the previously obtained temporary injunction against Marysville had expired, or was about to.
84 par 26; insertions by me.

Marysville argued that, first, the final payment claim sent by Troon to the non-certifying superintendent (Metier 3) should have been sent to the certifying superintendent (WT Partnership), who was elected, under the construction contract, to be the appropriate recipient for such a notice, and the competent party to then, if appropriate, issue the final certificate.[85] Second, at the time the final payment claim (addressed to the wrong superintendent) was sent by Troon, there were "significant and material defects which had been the subject of instructions directing rectification which had not been attended to [by Troon] and that while material defects existed, a Final Payment Claim could not be certified and therefore would not be paid".[86]

The court noted that it would be "inappropriate and impracticable" to address and assess all issues brought up by the parties "in the context of [Troon's] present application for interlocutory relief".[87] In addressing the balance of convenience, the judge was referred by Troon to the danger of "substantial damage" to its reputation if the application for the injunction was not granted, because it "tenders for public works and for medium-to-large sized projects which would require disclosure of such a demand in such tenders […] which in turn would be likely to jeopardise [Troon's] prospects of being preferred over other tenders", mentioning further it "has been operating for 134 years and in that time there has never been a claim or demand made against any of [Troon's] Bank Guarantees, a circumstance which is positively promoted by [Troon] to its clients, and which [Troon] asserts significantly contributes to [Troon's] reputation".[88] In its defence, Marysville also advanced the prospect of financial hardship on its part should the injunction against it be allowed,[89] therefore urging the court not to grant the injunction.

Troon had based its application on allegations of unconscionable conduct, and the breach of a negative stipulation in the underlying construction contract which, in the opinion of Troon, allowed recourse to the guarantee "but limited to the extent of its present or future costs, expenses, loss or damages".[90] While acknowledging that the contract provisions must be interpreted "in light of the agreed risk allocation" generally evidenced from the underlying contract,[91] Troon argued that a call on the guarantee, especially for the full amount (AUD 750k), was both breaching an implied negative stipulation and unconscionable conduct,[92] implying that only lesser damages or expenses were suffered and therefore recoverable under the guarantee.[93] Moreover, Troon alleged that Marysville acted unconscionable because it "failed to ensure that the Certifying Superintendent issued the Final Certificate under the Contract", thereby

85 par 31.
86 par 31; insertion by me.
87 par 37; insertion by me.
88 par 39; insertions by me. See also par 72.
89 par 40.
90 par 52.
91 par 48.
92 par 52.
93 par 64.

preventing the return of the guarantee and creating a situation which led to the call on the bank guarantee.[94]

Marysville responded to these issues by highlighting the fact that it would only retain the portion of the payment under the guarantee necessary to cover its current claims (and not the entire AUD 750k),[95] and that Troon had "agreed to contract in the terms that it did", including the clause relating to the independent guarantee, "and thereby assumed the risk that if a call was made upon the [independent guarantee] it would be [Troon] which was out of pocket".[96] Having regard to the construction contract, the judge sided with Marysville:

> "[T]he Contract in my view reflects the parties' intent that […] it is agreed that [Marysville] may make a demand on or use any of the security sum provided by [Troon], to pay for any costs, expenses, loss or damages which [Marysville] claims, as Principal under the Contract, it has incurred, or might in the future incur as a consequence of any act or omission on the part of [Troon] which the Principal asserts constitutes a breach of the Contract by [Troon]",[97]

since the terms of the security provisions in the contract are "broad and enabling",[98] evidencing, overall, the intention that Marysville "may access the security without having to establish any relevant breach of Contract by [Troon] or the existence of any relevant extant contractual claim or entitlement".[99] This scheme allocated the risk to Troon to "be out of pocket pending final determination of any disputes in respect of any costs, expenses, loss or damage which [Marysville] claims has been incurred, or which [Marysville] claims might be incurred in the future",[100] and permitted Marysville to have "recourse even in the face of substantial disputation in relation to relevant underlying rights and entitlements arising out of, or in connection with the Contract".[101]

Digby J reiterated the position under Australian law that independent guarantees and performance bonds in the construction or engineering context should be free from judicial interference, except for cases of fraud, instances of (statutory) unconscionability, or to enforce a negative stipulation in the underlying contract.[102] In remarkable clarity he acknowledged:

> "The undesirable concomitant consequence of departing from the usual approach and application of the rule to which I have referred is that by restraining recourse to a performance bond pending trial in relation to issues in dispute related to recourse will usually, in effect, afford final relief by deferring the principal benefit intended to be secured by the performance guarantee contrary to the intent and the fundamental bargain of the parties in relation to access to security and contrary to the parties' agreement as to the commercial allocation of risk as to this aspect of the Contract."[103]

[94] par 53 and 60.
[95] par 79.
[96] par 83; insertions by me.
[97] par 89; insertions by me.
[98] par 91.
[99] par 93; insertions by me.
[100] par 94; insertions by me.
[101] par 95.
[102] par 96.
[103] par 97.

Moreover, he emphasised that a court "should take into account the commercial purpose" of security such as independent guarantees in construction projects, "and not too readily favour a construction which is inconsistent with the parties' agreed allocation of risk as to which party would be out of pocket pending resolution of disputes".[104] On the grounds that

> "at all material times the defendant [Marysville] had reasonable bases upon which to assert that [Troon] had breached the Contract by failing to attend to formally notified defective and incomplete work […] and that similarly [Marysville] had reasonable bases upon which to make a claim and assert costs loss, expense and damage",[105]

including costs, damages and claims which might be incurred in the future,[106] the judge was "not persuaded that at the date of attempted recourse [Marysville] made 'a claim' for amounts that it knew it had no entitlement to".[107] He rejected the allegation that Marysville "has conducted itself in any way which could be described as constituting serious misconduct, or clearly unfair or unreasonable conduct in relation to [Troon]",[108] and given that the certifying superintendent WT Partnership never received the Final Payment Claim from Troon,[109] and even if it had, would not have issued the Final Certificate because of the outstanding defects and shortcomings,[110] sided with Marysville and refused the interlocutory and permanent injunction.[111]

The decision by the Supreme Court of Victoria to strike down the application by Troon for interlocutory or permanent relief against the beneficiary of the guarantee (Marysville) is certainly a commendable one. Especially the clear acknowledgment[112] of the problems inherent in any judicial interference with the mechanisms of independent guarantees, and the reference to the "agreed allocation of risk as to which party would be out of pocket pending resolution of disputes",[113] must be welcomed. It indicates a keen awareness of the reasons why parties, especially in the construction industry, choose to require an independent guarantee as security for performance – it allows them, in situations of disagreement over the occurrence or extent of damages or breach, fast and reliable access to cash needed for rectification. Thus, this case gives effect to the risk-allocation function that independent guarantees seek to serve in business transactions, especially in construction and engineering projects. It also reinforces the notion that interference with the call on, and subsequent payment of, an independent guarantee should be kept to a minimum so that the principle of independence is fully appreciated. This consideration, generally, militates against allowing judicial intervention.

[104] par 98.
[105] par 107; insertions by me.
[106] par 108.
[107] par 106; insertion by me.
[108] par 109; insertion by me.
[109] par 114.
[110] par 115.
[111] par 126.
[112] expressed in par 97 of the decision.
[113] See Digby J's reasoning in par 98.

Interestingly, the initial court orders granting a temporary injunction against Marysville preventing it from calling up the guarantee, were mitigated in their severity – the court, while granting the temporary injunction, nevertheless ordered Troon to pay Marysville the amount that Marysville had already, at that point, paid a third party to rectify some of the urgent construction defects (AUD 240k). To an extent, this prevented Marysville from being "out of pocket" for the time being, despite being prohibited from calling up the guarantee. If a court must decide to interfere with the mechanism of independent guarantees, then such an additional order, it is argued, at least softens the injury inflicted on the beneficiary.[114] The Supreme Court of Victoria, however, went further and fully restored the independence of the bank guarantee by denying the applicant's request for interlocutory or permanent relief, thereby separating the two transactional spheres (the guarantee transaction on the one hand, and the underlying construction agreement on the other hand). Regrettably, it is respectfully submitted that this judgment is not a well-structured decision. Certain issues are repeatedly returned to without necessity, and presented in an almost random manner. This is unfortunate, because this could effectively impede the full appreciation of the legal reasoning stated by the judge, and the merits of this case. Still, one must concede that this is probably owed to the order of evidence submitted by the parties, and the particular way in which counsel argued the case.

3.3 *Laing O'Rourke Australia Construction Pty Ltd v Kawasaki Heavy Industries*

The third Australian case in this article is a judgment by the Supreme Court of New South Wales.[115] It dealt with a rather complex factual situation stemming from a construction project in which JKC Australia LNG Pty Ltd (here "JKC") acted as main contractor for a gas storage facility, while a "consortium" was engaged as subcontractor to JKC. The consortium was formed by two parties, Laing O'Rourke Australian Construction Pty Ltd ("LOR") and Kawasaki Heavy Industries Ltd ("Kawasaki"). According to the consortium agreement between the two members, LOR was responsible for civil works in the project, and Kawasaki for various other tasks.[116]

In the contract with the main contractor JKC, the consortium agreed that a performance bond had to be procured which secured the consortium's obligation towards JKC.[117] The bond, referred to as the "Kawasaki Bond", was issued by a third party. Internally the members of the consortium, LOR and Kawasaki,

[114] At the same time, admittedly, one may argue that this approach is inconsistent or illogical: first, there must have been very serious doubts as to the material entitlement of the beneficiary (here Marysville), under the underlying transaction, to call up the guarantee, so as to motivate the court to interfere. Then, however, the court sees a necessity to come to the aid of the beneficiary by granting a payment order, outside the guarantee, against the applicant (as in this case, against Troon for the amount of AUD 240k).

[115] *Laing O'Rourke Australia Construction Pty Ltd v Kawasaki Heavy Industries* [2017] NSWSC 541.

[116] par 10-12.

[117] par 8.

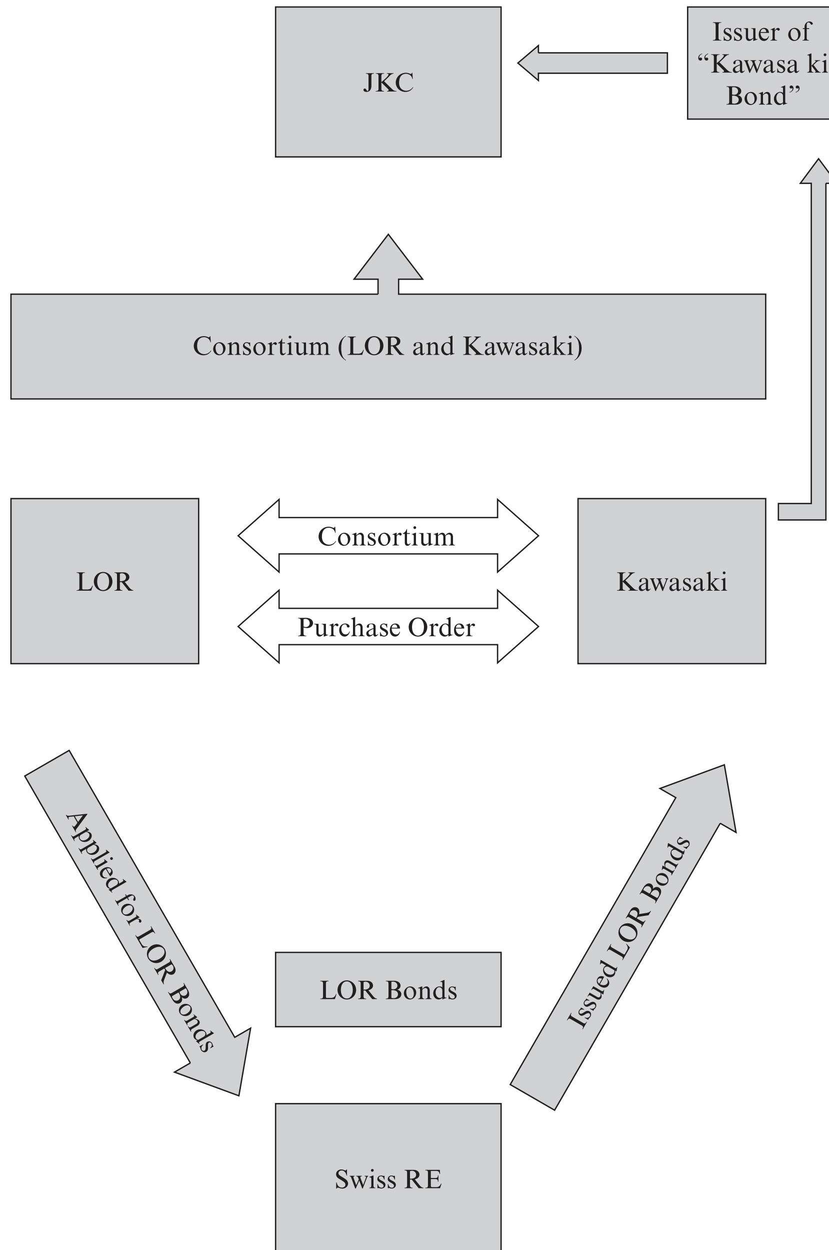
agreed that Kawasaki would apply for it in its own name and on behalf of LOR (hence the name "Kawasaki Bond").[118]

Further, the consortium agreement contained a clause which stipulated that if JKC made a call on the Kawasaki Bond, the two members of the consortium (LOR and Kawasaki) would have to contribute to and cover the reimbursement claim by the issuer of the Kawasaki Bond "in proportion to their liability" as determined under the consortium agreement.[119] In order to protect itself in such an event, Kawasaki required LOR, in turn, to provide several "surety bonds" in favour of Kawasaki. The duty of LOR to acquire these "surety bonds" (referred to as "LOR Bonds") in favour of Kawasaki arose for some from the consortium agreement,[120] and for others from a separate agreement between LOR and Kawasaki (referred to as the "Purchase Order").[121]

LOR facilitated the issuance of all necessary LOR Bonds through a successful application to Swiss Re International SE,[122] which duly issued them to Kawasaki. These LOR Bonds were drafted to be independent and payable on demand.[123]

The relationships between the different parties can be schematically presented thus:

[118] par 9.
[119] par 13.
[120] par 14.
[121] par 16-17.
[122] In fact, two additional guarantors participated in the issuance of these guarantees. For purposes of this case discussion, however, it is assumed that *Swiss Re International SE*, by itself, issued the guarantees.
[123] par 25.



When serious delays in the execution of the work by the consortium occurred, JKC claimed about AUD 100m in damages from the consortium.[124] While threatening to cancel the contract with the consortium,[125] JKC made no call

[124] par 20.
[125] par 22.

on the Kawasaki Bond.[126] LOR and Kawasaki blamed each other, internally, to be the responsible party for the delay and problems relating to the work the consortium had to perform,[127] and planned to refer their internal dispute to arbitration.[128]

Before the arbitration tribunal was constituted, however, Kawasaki called up several of the LOR Bonds. The very next day, LOR was granted an ex parte interlocutory injunction by a court to restrain Kawasaki from calling up the bonds,[129] after which Kawasaki withdrew its calls on the bonds "pending the outcome of these proceedings".[130] LOR requested to have the injunction against Kawasaki extended and continued pending the determination of the underlying dispute by an arbitral tribunal, to be appointed in accordance with the underlying contract (the consortium agreement between LOR and Kawasaki).[131]

Two issues were put before the court by LOR: First, a negative stipulation defence,[132] that is a promise by the beneficiary of the LOR Bonds (Kawasaki) to LOR in the underlying consortium agreement and the "Purchase Order" that it would not call on the LOR Bonds, until and unless JKC has made a call on the Kawasaki Bond. Second, LOR addressed the issue of balance of convenience, arguing that this test favoured the continuation of the injunction.[133]

Negative stipulation defence

The court analysed the "[s]erious question"[134] of negative stipulations and promises in the underlying agreement between beneficiary and applicant which may prohibit the beneficiary from exercising its rights under an independent guarantee or performance bond. Several recent Australian decisions were referred to, and the applicable legal principles laid out.[135] Stevenson J interpreted LOR's case as that "on the proper construction of the Consortium Agreement and the Purchase Order, the condition precedent to Kawasaki's entitlement to call on the [LOR] Bonds is a call on it by JKC under the Kawasaki Bond".[136]

[126] par 21.
[127] par 23.
[128] par 24.
[129] par 2. The injunction was granted by Bell J, who was also a judge at the Supreme Court of New South Wales.
[130] par 3. "These proceedings" were the ones leading to this judgment.
[131] par 5.
[132] Note that the court, with reference to *Simic v NSW Land and Housing Corporation* [2016] HCA 47, explained it as a "breach of a contractual promise not to [call up the bond] unless certain conditions are satisfied" (par 30; insertion by me).
[133] par 27.
[134] See heading inserted in the judgment before par 30.
[135] par 30-40. The referenced cases include *Simic v NSW Land and Housing Corporation* [2016] HCA 47, *Clough Engineering Ltd v Oil and Natural Gas Corporation* Ltd [2008] FCAFC 136; 249 ALR 458, *Lucas Stewart Pty Ltd v Hemmes Hermitage Pty Ltd* [2010] NSWCA 283, *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1998] VSCA 40, *RCR O'Donnell Griffin Pty Ltd v Forge Group Power Pty Ltd (in liquidation)* [2016] QCA 214, and *CPB Contractors Pty Ltd v JKC Australia LNG Pty Ltd* [2017] WASC 112 (discussed above).
[136] par 38; insertion by me.

Another question in this context was examined, namely whether it made a material difference that some of the LOR Bonds were established pursuant to the consortium agreement, and some pursuant to the "Purchase Order". This could have been relevant, as the "Purchase Order" introduced the application of some supplementary terms and conditions, one of which was a "no injunction" stipulation which attempted to curtail the rights of LOR to seek judicial relief through an injunction.[137] The judge held that none of the "LOR Bonds" were subject to these additional terms and conditions in the "Purchase Order", and that all LOR Bonds were subject to a particular clause from the "Consortium Agreement"[138] to the effect that: (a) Kawasaki had to procure the "Kawasaki Bonds" in favour of JKC to secure the consortium's performance under the subcontract with JKC;[139] (b) if a call was made on the Kawasaki Bond by JKC, then both LOR and Kawasaki had to "contribute to the call 'in proportion to their liability', as between themselves, under the Consortium Agreement";[140] and (c) that if LOR and Kawasaki found themselves unable to ascertain which party was responsible for the event that caused the call on the "Kawasaki Bond" by JKC, "then such call will be borne by [Kawasaki] until it is determined by the Steering Committee [which comprised two representatives of each [LOR] and Kawasaki]."[141]

Moreover, the agreement provided that if the "Steering Committee" failed to reach a decision on the internal liability between LOR and Kawasaki, the parties would refer the dispute to an arbitral tribunal.[142] Based on this, the judge concluded:

> "Thus, the parties agreed if it was 'not possible to determine' which of Kawasaki and [LOR] was, in effect, responsible for the event that led to the call by JKC on the Kawasaki Bond, the dispute would be referred to arbitration. The fact that the parties agreed that, pending the determination of the Steering Committee, the burden of any call by JKC would be 'borne' by Kawasaki, suggests that it was the agreement of the parties that, until such a determination was made (and, in the event of deadlock on the Steering Committee, the matter be determined by arbitration), Kawasaki could not call on the [LOR] Bonds, notwithstanding a call made by JKC on the Kawasaki Bond.
>
> However, as JKC has not made a call on the Kawasaki Bond, this question does not arise."[143]

Effectively, the court acknowledged that the clause in the consortium agreement, to which the LOR Bonds were subject, contained a negative stipulation or covenant which restricted Kawasaki's rights to call up the LOR Bonds, even though the LOR Bonds were issued by the guarantor to Kawasaki as independent undertakings. Kawasaki was substantially prohibited from submitting a demand

[137] par 45-47.
[138] par 48. Reaching this decision involved a lengthy deliberation by the court, which is omitted for purposes of this case analysis. See, especially, par 42-58.
[139] clause 14(a) of the Consortium Agreement, see par 41 and 61.
[140] clause 14(b) of the Consortium Agreement, see par 41 and 62.
[141] par 41 and 63; most insertions in the original.
[142] par 64. The provisions relating to the "Steering Committee" and the dispute resolution via arbitration were contained in clauses 10.3(d) and 19 of the Consortium Agreement between LOR and Kawasaki.
[143] par 65-66; insertions by me.

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to the guarantor under the LOR Bonds, unless JKC had made a demand on the Kawasaki Bond prior to that and a determination was made by the steering committee or arbitration as to the individual responsibility between Kawasaki and LOR.

Balance of convenience

As to the second issue raised by LOR, the court expressed its opinion that the "balance of convenience favours, strongly, the continuation of the existing injunction"[144] against Kawasaki because, inter alia, as a "large company" with considerable shareholder equity and available means of liquidity it would not be "substantial[ly] prejudice[d]"[145] if the injunction remained in place. To support this contention, the court relied on several additional considerations, such as the risk of diminishing LOR's "prospects of bidding for participation in an unrelated project"[146] and potential reputational damages if a call on the bonds by Kawasaki was not prevented by extending the injunction.[147] Most notable, however, was the following concern that motivated the court to agree to grant the continuation of the injunction against Kawasaki:

> "[N]o arbitral tribunal has yet been established to deal with the underlying dispute. [LOR] thus cannot, at the moment, approach the arbitral tribunal to seek an order from it restraining Kawasaki from calling on the [LOR] Bonds. If the current restraint is dissolved, [LOR] will, in substance, forever lose the right to restrain a call on the [LOR] Bonds. It will, no doubt, then have to account to the issuers of the bonds in accordance with its arrangements with those parties, and will only be entitled to recoup whatever loss it thereby suffers if and when it is successful at arbitration".[148]

In consideration of the elaborations as to the two main issues raised by LOR, the court confirmed and extended the injunction against Kawasaki based on a negative promise it had given to LOR in the underlying agreements.[149]

This case should serve as a warning to parties requesting, and subsequently relying on, a performance bond or independent guarantee which is subject to Australian law, or potentially litigated in an Australian forum. Beneficiaries of such instruments of security must be aware of the growing readiness of Australian courts to exercise their discretion to enjoin calls if the underlying contract or agreement contains language that may be construed as conditions precedent or negative covenants/stipulations. The often-cited expectation that independent guarantees and performance bonds are "as good as cash in hand" is progressively called into question. While this development can promote, or restore, justice and fairness in certain situations, it seriously undermines the notion of legal certainty – an essential feature of independent guarantees and performance bonds – and the property of these independent undertakings as

[144] par 86.
[145] par 88; insertions by me.
[146] par 91.
[147] par 94.
[148] par 89; insertions by me.
[149] par 28-29, 95-96.

"risk allocation devices". It is clear that the negative stipulation or negative covenant defence is an integral aspect of the Australian law relating to independent guarantees and performance bonds.[150]

However, owing to LOR's decision to seek judicial relief not against the issuer of the LOR Bonds (Swiss Re),[151] but rather only against the beneficiary (Kawasaki),[152] the dispute relating to the interpretation of the underlying agreement(s) and its potential bases for an injunction was at least confined to the members of the consortium. Any involvement of the issuer of the LOR Bonds was neither established nor sought. Instead, the dispute was deliberately kept between the two appropriate parties (LOR and Kawasaki) who agreed on the negative promise in their underlying contract. One could advance the argument, therefore, that theoretically the independence of the LOR Bonds, strictly speaking, was not questioned; rather, the members of the consortium enforced the terms and conditions of their consortium agreement, and did so between themselves without drawing the issuer into the litigation.[153]

Two further comments relating to the terminology employed by the court can be made: For clarity's sake, in approaching the first substantive issue advanced by *LOR*, that is the reliance on the negative stipulation in the underlying agreement(s), the court could have used the well-established expressions "negative stipulation defence" or "underlying contract defence" to describe, more aptly, the nature of LOR's first defence. Instead, the court explored the issue based on terminology and descriptions borrowed from, inter alia, cases such as *Simic v NSW Land and Housing Corporation*,[154] and *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd*.[155] Had the court used the negative stipulation/underlying contract defence terminology, it is suggested, it could have made the point even more clearly. Of additional concern is the fact that the court repeatedly used the expression "unconditional" to describe the performance bonds.[156] As was remarked above in the context of *CPB Contractors v JKC,* performance bonds and independent guarantees are almost never unconditional, because they mostly require at least a written demand by the beneficiary and possibly submission of further documents to trigger the payment obligation under the instrument. The use of the term "unconditional", in this context, should be avoided.

[150] Due to the fact that "standby letters of credit" are, essentially, very similar to these independent guarantees and bonds, it is probably correct to assume that standbys would also be so treated.
[151] par 26.
[152] par 27.
[153] See, for example, Hugo (n 4) 446.
[154] [2016] HCA 47.
[155] [2008] FCAFC 136; 249 ALR 458.
[156] The use of the word "unconditional" was not just owed to quoting from any contractual provisions, but employed in order to emphasise, presumably, the independent nature of the bonds.

4 *Unconscionability in the law of Singapore relating to independent guarantees and performance bonds payable on demand*

Two recent decisions by the Singapore High Court investigated the doctrine of unconscionability as used in Singaporean law to prevent a call on an independent guarantee or performance bond payable on demand.

4.1 *Tactic Engineering v Sato Kogyo (S)*

The first Singaporean case[157] concerned a dispute between two construction companies relating to engineering and construction work for the extension of the public transport system in the country. Sato Kogyo was awarded a construction project as the main contractor, and subcontracted certain works to Tactic Engineering. The subcontract stipulated that the main contractor be allowed to retain, as security, five per cent of the money due for already executed work. The subcontract value stood at about SGD 24m, meaning that the main contractor was, after completion of the whole subcontract, eligible to retain up to about SGD 1.2m. When the subcontractor encountered financial difficulties, it negotiated with the main contractor for the release of the retained sums to provide cash for its operations. In return, however, the subcontractor had to obtain a performance bond to cover the sum to be released. The subcontractor, accordingly, acquired a performance bond by a guarantor in favour of the main contractor, payable on demand, for the maximum amount of about SGD 1.2m.

Because it was discovered that the subcontractor owed the main contractor some SGD 220k from another construction project (identified as "MCE" project)[158] before the retention money was released to the subcontractor, the two parties agreed on a set-off of the MCE project money against the to-be-released retention money. Nevertheless, the subcontractor sent the main contractor payment instructions for the full retention money which had accumulated up to that stage of the construction (SGD 1.18m), without deducting the MCE project amount (which should have reduced it to just under SGD 1m). After an administrative error, however, the main contractor released the full SGD 1.18m to the subcontractor as per its inaccurate payment request.

Despite the cash injection, the subcontractor was unable to perform its construction work satisfactorily and on time, which necessitated the main contractor to make alternative arrangements to ensure completion of the project. As a result, it incurred additional expenses,[159] and made several claims against the subcontractor over the course of two years, including several warnings that it may have to call up the performance bond if payment was not forthcoming. When the main contractor eventually made calls on the bond – but before they were accommodated by the guarantor – the subcontractor succeeded in enjoining the main contractor from obtaining payment under the bond.[160]

[157] *Tactic Engineering Pte Ltd (in liquidation) v Sato Kogyo (S) Pte Ltd* [2017] SGHC 103.
[158] par 4.
[159] par 5. These additional charges were referred to as "back charges".
[160] Unfortunately, the judgment is not entirely clear on this point. Although it is claimed at par 1 that the injunction had prohibited "*inter alia* calling on the Bond", it is evident from par 5 that in fact such calls had already been made (yet they remained unpaid) when the injunction was originally granted.

The main contractor successfully applied to the High Court to set aside this injunction, upon which the subcontractor appealed the lifting of the injunction, and advanced arguments based on the doctrine of "unconscionability as grounds for sustaining the Injunction".[161] It argued that the main contractor should not be allowed to claim under the bond any money which related to a different construction project (the MCE project money), or any administrative charges. Furthermore, the subcontractor alleged that the main contractor's "computation of back charges was unconscionable".[162]

Besides delving into the rather complicated calculations of different claim positions,[163] the court explored the position in Singaporean law relating to the unconscionability exception to the independence principle in demand guarantees and performance bonds. With reference to two prominent Singaporean cases,[164] it was explained that courts should generally show restraint in interfering with the risk allocation provisions that parties freely bargained for,[165] that the applicant requesting the court's interference must "establish a strong prima facie case of unconscionability",[166] and that a "genuine dispute"[167] between the parties of the underlying contract as to the beneficiary's entitlement to call up the guarantee would usually dismiss the application of the unconscionability defence.

Applying these principles to the case at hand, the court held that there was no unconscionable conduct on the main contractor's part, and affirmed the decision to set aside the injunction. Because the main contractor had agreed to release the retention money and relied on the negotiated set-off regarding the MCE project money, it was not per se unconscionable to include this position, derived originally from a separate construction project, into its calculation to justify the demand on the bond.[168] Likewise, the inclusion of administrative charges into its calculation was no clear indication of unconscionable behaviour, since "[i] was at least arguable that [the main contractor] could premise the call on the Bond on its losses, regardless of whether they were termed 'Administrative Charges' or otherwise".[169] Lastly, it was held that the "back charges", which probably[170] constituted the most significant share of the amount claimed under the performance bond, "were not so excessive or abusive as to establish that

[161] par 6.
[162] par 6.
[163] par 7-8.
[164] par 9. The two cases were *Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 3 SLR(R) 198, and *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] 3 SLR 352.
[165] par 9(a).
[166] par 9(b).
[167] par 9(c). It was later also referred to as a "genuine contractual dispute", see par 17.
[168] par 10. Moreover, evidence before the court showed that even without this payment position the main contractor's claim calculation "was well in excess of the Bond", meaning that even without the MCE project money the beneficiary (main contractor) had gathered sufficient outstanding payment positions to explain a call under the performance bond for the full available balance (par 11).
[169] par 12; insertions by me.
[170] It must be noted that the main contractor apparently gave no precise breakdown of the amount(s) claimed under the performance bond; the payment positions discussed by the court stem from invoices and other communications sent between the main contractor and subcontractor – not statements sent by the main contractor to the guarantor.

[main contractor] was unconscionably bloating the numbers to justify the call on the Bond", so that the subcontractor failed to "show that it was 'reasonably apparent' that there was unconscionable conduct".[171]

Foo Chee Hock JC, for the court, concluded that "after considering the evidence holistically, it was apparent that [the subcontractor's] case fell far short of a strong *prima facie* case of unconscionability. Rather it appeared to be clutching at straws to make out a case by disputing various components of [main contractor's] claim. In my judgment, the overall tenor of the evidence pointed to a genuine contractual dispute".[172] Therefore, the injunction against the beneficiary, the main contractor, was set aside, so that it could proceed to enforce the performance bond against the guarantor.

As was expressly acknowledged, judicial relief based on unconscionability requires an investigation of the "whole context of the case"[173] and "considering the evidence holistically".[174] Naturally, this goes against the important separation of the different contractual spheres (principle of independence), and seeks to concern the performance bond or independent guarantee transaction with issues originating from the underlying contract.[175] If the courts do not adhere to the call for restraint, fortunately reiterated yet again by the court,[176] there is a real danger that beneficiaries will either go back to requiring cash deposits, or insist on protection clauses as used in *CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd*,[177] as they might develop serious doubts about the convertibility of such instruments under Singaporean law.

On a more positive note, this decision emphasised the need to "establish a strong prima facie case"[178] to invoke the unconscionability defence, and recounted the principle that a "genuine dispute/genuine contractual dispute"[179] between the parties of the underlying agreement is a strong indication against the presence of unconscionability.

4.2 *LQS Construction Pte Ltd v Mencast Marine Pte Ltd*

Unconscionability and its potential impact on independent undertakings featured also in the second Singaporean case[180] discussed in this article. Mencast Marine Pte Ltd (referred to as "Mencast" in this case analysis) engaged LQS Construction Pte Ltd (here referred to as "LQS") to execute a construction project. In terms of this construction contract, LQS was required to provide a performance bond in favour of Mencast covering ten per cent of the contract

[171] par 14; insertion by me.
[172] par 17; insertions by me.
[173] par 9(b).
[174] par 17.
[175] Indeed, this argument is one of the main reasons that commentators usually advance when criticising the unconscionability defence in the law relating to independent guarantees.
[176] par 9(a).
[177] [2015] 3 SLR 1041 (CA).
[178] par 9(b).
[179] par 9(c) and 17.
[180] *LQS Construction Pte Ltd v Mencast Marine Pte Ltd* [2017] SGHC 148.

amount. On application of LQS, and after lodging security for reimbursement,[181] First Capital Insurance Ltd issued such a performance bond to Mencast. After construction had begun, LQS sent periodic payment claims to a construction expert hired by Mencast who then certified the work completed, and the pay correspondingly due by Mencast to LQS.[182] When the construction schedule was not kept, and a granted time extension was missed, the parties had a dispute as to the reasons for delay, and the extent of unfinished work.[183] Mencast refused to issue the handing-over certificate, which would have enabled LQS to obtain further payment, and urged LQS to proceed with the construction.[184] When it did not, Mencast terminated the construction contract.[185]

LQS, on the other hand, took to the courts to enforce what it thought was due to it (contract price, some money previously retained as security, and additional payment for construction variations requested by Mencast).[186] The very next day, Mencast made a demand against the guarantor on the performance bond for the full balance.[187] Before the demand was accommodated by the guarantor, LQS applied to the High Court for an ex parte injunction against Mencast from receiving money, and against the guarantor from paying, under the performance bond.[188] After hearing allegations that Mencast had acted unconscionably, the injunction was granted against the beneficiary (Mencast) which, in turn, sought to have the injunction set aside.[189] After Mencast offered testimony and other evidence to support its case, the court agreed that it had not acted unconscionably and lifted the injunction.[190] Because the court discovered that LQS had departed from the truth in its ex parte injunction application ("not made full and frank disclosure of all material facts […] suppressed or effectively misrepresented certain crucial facts";[191] had made "misrepresentation";[192] and "not only suppressed information […] but had also blatantly misrepresented facts"[193]), the court "found it appropriate to discharge the injunction on the basis of LQS's material non-disclosure".[194]

[181] Interestingly enough, the judgment (par 3) revealed the fact that *LQS* paid a deposit of less than ten per cent of the sum guaranteed under the performance bond, leaving the guarantor *First Capital Insurance*, presumably, largely unsecured.
[182] par 5.
[183] par 6-9.
[184] par 9.
[185] par 12.
[186] par 13.
[187] par 14.
[188] par 15.
[189] par 16-17.
[190] LQS was not represented at this hearing due to various complications which do not merit discussion for purposes of this case discussion. Furthermore, several additional legal proceedings and motions relating to, inter alia, a request to declare the performance bond inoperative, have the collateral deposited for its issuance returned, and a winding-up application against *LQS* initiated by a creditor, are also left unaddressed here.
[191] par 35; insertion by me.
[192] par 41.
[193] par 44; insertion by me.
[194] par 44.

"For completeness",[195] however, the court disseminated the merits of the case and the previous allegations advanced by LQS to support its claim of unconscionability against Mencast, which included:[196] alleged lack of proper notice of outstanding work, refusal to issue the handing-over certificate and, because of these reasons, Mencast's reliance "on its own breach to gain a benefit by calling on the Performance Bond"; that the call was simply a "retaliatory move" because LQS itself had initiated judicial proceedings and, in any event, the demand for the entire available balance of the performance bond was unfair "when any amount in dispute was likely to be much less".

In light of the evidence that Mencast presented, almost all issues were deemed by the court to be "genuine disputes"[197] at most, and thus below the threshold of constituting unconscionable conduct. Apart from that, it was confirmed that a beneficiary's "right to call an on-demand performance bond was not subject to any preconditions, such as first giving notice to LQS as to the nature and cost of repairs to be undertaken"[198] and that, in any event, Mencast had in fact provided ample notice and details regarding outstanding works. In response to the complaint that the entire bond amount was called up even though the actual damage may be lower, it was held that "the court is not involved in an exercise of quantifying damages, but only in ensuring that the amount of the bond called upon is not unconscionable".[199]

Similar to *Tactic Engineering v Sato Kogyo*, discussed above, this case contains the accurate yet problematic statement that the question of "[w]hat constitutes unconscionability will depend on the facts of each case".[200] Parties looking for firm and dependable guidance will be left disappointed, it is respectfully submitted.

The court, fortunately, restated the principle that "[i]n calling upon an on-demand performance bond, there is no requirement for the beneficiary […] to establish any breach by the obligor […] of the underlying contract on which the bond is based, before the issuer […] comes under an obligation to pay out under the bond",[201] and eventually made it clear that an injunction against a beneficiary will be set aside if the disagreement between the parties to the underlying contract is a "genuine dispute". The fine line between contractual disputes, which leave performance bonds or independent guarantees unscathed, and more questionable conduct, which might motivate the granting of injunctions, remains challenging to navigate.

[195] par 45.
[196] These reasons, and further elaborations relating thereto, were listed at par 26.
[197] par 45, 49, 56, 57.
[198] par 48.
[199] par 61, with reference to the case *Eltraco International Pte Ltd v CGH Development Pte Ltd* [2000] 3 SLR(R) 198.
[200] par 31; insertion by me.
[201] par 30; insertions by me.

5 *Independent guarantees, performance bonds and standby letters of credit: effective risk allocation devices*

Independent guarantees, performance bonds payable on demand, and standby letters of credit owe their popularity, to a considerable extent, to the independence principle and the ability to be employed as an efficient risk allocation device[202] in commercial transactions. The following Canadian case is clear evidence of that, and complements what was observed in the other cases above.

5.1 *Jabneel Development Inc v Lamont (Town)*

In *Jabneel Development Inc v Lamont (Town)*,[203] a real estate and development company (Jabneel) entered into a contract with the Canadian town of Lamont for the development and subsequent sale of certain sections of land within the town. Jabneel engaged the Canadian Imperial Bank of Commerce to issue a standby letter of credit to secure its performance under the development agreement. The standby letter of credit was issued for the amount of CAD 406,500 and delivered to Lamont, the beneficiary. After activities under the development agreement had commenced, Jabneel experienced financial and operational difficulties. When the expiration date of the standby letter of credit was not further extended by the issuer, Lamont submitted a demand under the standby to the issuer (Canadian Imperial Bank), and was paid the full sum which it held in an interest bearing account. Jabneel and Lamont were not able to overcome their disagreements relating to questions of performance, rectification and liability, leading Lamont to terminate eventually the development agreement. Jabneel took to the courts and applied to have the funds from the standby letter of credit paid/returned to it.[204] The application was partially granted on an interim basis in a summary judgment of first instance, and all except CAD 100,000 was ordered to be (re)paid to Jabneel "pending the determination and assessment of costs". Lamont appealed the decision.

On appeal, Nielsen J sided with Lamont and reversed the previous decision. Considering the insolvency of Jabneel, as admitted by its counsel, the court argued that if the proceeds from the standby letter of credit "are returned to Jabneel, and ultimately, a court determines that Lamont is entitled to damages up to or exceeding $406,500, Lamont would, in all likelihood, be unable to realize on any damages in excess of the $100,00 amount. Therefore, while Lamont may have an entitlement to damages up to the total amount of the Letter of Credit, by having been directed to release the amount in excess of $100,00, Lamont's position would have been irrevocably prejudiced". The court decided that Lamont, the beneficiary of the standby, "shall hold all the funds pending a determination of its entitlement to receive funds from the security posted by Jabneel and shall account for such funds".

[202] The term or concept of "risk allocation (device)" was acknowledged in several of the above cases (*CPB Contractors v JKC*; *H Troon v Marysville*; *Laing O'Rourke v Kawasaki*; and *Tactic Engineering v Sato Kogyo*).

[203] [2016] Alberta Court of Queen's Bench AJ No 266.

[204] This was the trial decision, *Jabneel Development Inc v Lamont (Town)* [2015] Alberta Court of Queen's Bench AJ No 847.

This case, while certainly not groundbreaking, reiterates clearly one of the main reasons why independent guarantees and standby letters of credits are used frequently in business transactions such as construction, sophisticated service or development projects – they serve as very effective risk allocation devices. This is due to the independence principle, which distinguishes these security instruments from accessory suretyship or "traditional/true" guarantee agreements. The beneficiary is able to obtain payment from the issuer as soon as a compliant demand is made, irrespective of objections or challenges from the applicant.[205] Any disputes relating to the occurrence of a breach of the underlying contract, the extent thereof, and the amounts due following such a breach (if any), will have to be resolved at a later stage.[206] Pending this resolution, the beneficiary should be allowed to hold the money, and it is for the applicant to initiate litigation if it wishes to have the money turned over – after the facts relating to liability and damages are properly determined. This may entail a full trial, the engagement of expert witnesses and presentation of evidence. Giving effect to this fundamental aspect of independent guarantees and standby letters of credit, often summarised as "pay first – argue later",[207] is even more important in situations where the applicant is, or is likely to become, insolvent because proceeds returned to it would under most legal systems become part of the insolvent estate and subsequent reversal of payment will thus become legally impossible. *Jabneel Development Inc v Lamont (Town)* is a good example of this line of reasoning, and the notion that independent undertakings like demand guarantees and standbys should be paid in accordance with their terms in order to fulfill the intended risk-allocation function.

6 *Independent guarantees, performance bonds, and standby letters of credit: Current issues and international legal perspectives*

The presented cases clearly show that the principle of independence continues to be the central issue in many decisions. The boundaries of independence and possible inroads vary from jurisdiction to jurisdiction, and some legal systems and courts seem to be particularly occupied with certain issues. For example, applicants in Australia often try to rely on the negative stipulation defence to obtain injunctions against beneficiaries of independent guarantees and performance bonds; Singaporean courts regularly need to pronounce on disputes in which unconscionable conduct is alleged to break through the independence of guarantees and bonds. In order to be able to predict possible future developments in the law relating to independent guarantees, parties in South Africa – and other countries – are well-advised to pay attention to these international cases.

[205] As observed above in the *CPB Contractors v JKC* litigation, exceptions based on fraud or serious abuse are well-established in most jurisdictions.

[206] Several of the above decision, of course, questioned this principle by allowing, or at least considering, an injunction against the beneficiary (or issuer/guarantor).

[207] Bertrams *Bank Guarantees in International Trade* (2013) 73; and Dunham "The use and abuse of first demand guarantees in international construction projects" 2008 *International Construction Law Review* 273, 290.

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The effect of the 2017 changes to the Office of the Tax Ombudsman

THABO LEGWAILA*

1 *Introduction*

The South African Office of the Tax Ombud ("OTO") was created by the Minister of Finance in terms of section 259 of the Tax Administration Act 28 of 2011 ("TAA") in 2013 to deal with problems of an administrative nature between the South African Revenue Service (SARS) and taxpayers. The OTO was explicitly intended to provide taxpayers with a low-cost mechanism to address administrative difficulties that cannot be resolved by SARS.[1] In effect, the OTO is responsible for providing easily available remedies to taxpayers where taxpayers have been aggrieved by SARS administrative processes. This would thereby ensure commitment to governance by tax officials engaged in the implementation of tax laws and deal with maladministration of such laws.[2]

Legislative provisions creating and governing the OTO[3] have not been amended since enactment in 2012 until 2017 with the enactment of the Tax Administration Laws Amendment Act 16 of 2016 ("TALAA"), which came into effect on 19 January 2017. This note analyses the changes made to the office of the OTO and analyses the effect that those changes have to the OTO's powers to protect taxpayers and afford taxpayers a mechanism to address administrative difficulties that cannot be resolved by SARS, as envisaged at the inception of the OTO. In so doing, this note explores the nature of the OTO, the original structure, mandate and powers of the OTO, the rationale behind the changes and the impact of the changes.

2 *The development of the tax ombudsman*

The word "Ombudsman" is a Swedish word meaning "representative". Its roots can be traced back to the Ombudsman for Justice which was established in Sweden in 1809. The history of the Ombudsman around the world could be described as a combination of three interrelated developments: proliferation (as regards numbers), diversification (as regards categories and types) and mutation and variation (as regards functions and purpose).[4] As a result, since 1809 many countries have adopted the concept of the Ombudsman, such that by 2006 the

* Professor of Law, University of Johannesburg.

1 National Treasury *Budget Review* (2012) 59.

2 See Letete "An analytical examination of the legal framework creating the tax ombudsman: Any hope for South African taxpayers?" 2013 *International Journal of Public Law and Policy* 444.

3 ss 5-21 of the TAA.

4 Gregory "The ombudsman observed" 1997 *The International Ombudsman Yearbook* 78.

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Ombudsman existed in 125 countries around the world, some at national and others at sub national levels.[5]

In the recent past, countries around the world have adopted a separate and unique office of the tax ombudsman to specifically focus on engagements between the tax authorities and the taxpayers in a non-judicial set up. This is generally mainly in light of the recognition of the importance of taxpayer rights and protection, and due to the uniqueness of the relationship between the taxpayer and the tax authorities. An essential element of this relationship is that tax authorities are vested with overarching powers to collect taxes and being monopoly service providers to the community in which taxpayers do not benefit directly from the taxes that these authorities collect from them.[6]

With further development and complexity of tax laws, resulting in the consequential complexities in the relationships between tax authorities and taxpayers, some countries have developed their taxpayer protection institutions from traditional ombudsmen to institutions with even greater powers and reach than the traditional tax ombudsmen. The most popular of these are the following: the United States of America's Taxpayer Advocate which was created in 1996 under the Taxpayer Bill of Rights Act 2;[7] the Mexican *Procuraduría de la Defensa del Contribuyente* ("PRODECON") which was created in 2011 by Article 18-B in the Mexican Fiscal Code of the Federation;[8] and the Australian Inspector-General of Taxation ("IGT") in 2003 by the Australian Inspector-General of Taxation Act of 2003 ("IGTA").[9]

3 *The South African OTO*

3.1 Appointment of the Tax Ombud

The original provisions of the TAA empowered the Minister of Finance to appoint a person as Tax Ombud for a renewable term of three years and under such conditions regarding remuneration and allowances as the Minister may determine.[10] The duration of three years was found to be too short by the appointed Tax Ombud, Judge Ngoepe, who made a request to the National Treasury to have the duration increased to five years. This request was based on a study of similar institutions within and outside South Africa, which found that, in most cases, tax Ombuds were appointed for five years and that the longer term will make it easier to recruit people with the right qualifications to the

[5] Serrano "The taxpayer's rights and the role of the Tax Ombudsman: An analysis from a Spanish and comparative law perspective" 2007 *Intertax* 331-340.

[6] Noroozi "The role of Inspector General of Taxation in Australia" (April 2016) 1 (https://taxpayerrightsconference.com/wp-content/uploads/2015/11/Noroozi_Final_Paper.pdf (accessed 27 July 2017)).

[7] Publ.L. 104-168, 110 Stat.1452; see https://www.irs.gov/advocate (accessed 31 July 2017).

[8] See http://www.prodecon.gob.mx/index.php/home/que-es-prodecon/historia (accessed 31 July 2017).

[9] See http://igt.gov.au/ (accessed 31 July 2017).

[10] s 14(1) of the TAA.

position.[11] Following this request, section 49 of the TALAA amended section 14(1) of the TAA by increasing the duration of the term to five years. According to the Explanatory Memorandum the amendment "aims to enhance the independence of the Tax Ombud by extending his or her tenure".[12] It is not clear how the increase in the term of the Tax Ombud would be directly attributable to an increase in independence. However, the increase in the tenure could achieve other equally important attributes of the OTO, such as consistency, stability, credibility and efficiency. The five-year term is consistent with terms of other like institutions elsewhere. For example, the Australian IGT is appointed by the Governor-General on a full-time basis for a period not exceeding five years.[13] Similarly, the Commissioner for the SARS is appointed for a renewable term of five years.[14]

3.2 Appointment of staff of the OTO

In its original form, section 15 of the TAA which governs the appointment of the staff of the OTO provided that the "staff of the office of the Tax Ombud must be employed in terms of the SARS Act and be seconded to the OTO at the request of the Tax Ombud in consultation with the Commissioner". This provision raised serious independence issues. In its very nature, and in order to discharge its obligations, the OTO needs to be independent from SARS. In addition, the OTO needs to be known and seen to be so independent. The lack of independence would deprive the OTO of credibility in dealing with complaints against SARS. Without credibility, taxpayers would not have confidence in the OTO and would thus not use the services provided by the OTO.

This provision also limited the staff sourcing capacity of the OTO, in that the staff of the OTO would consist solely of persons that worked for SARS and it did not allow the Tax Ombud to source staff from outside SARS. Cleary this created bias (albeit perceived) in favour of SARS over taxpayers, or at the very least created an impression of lack independence from SARS by the staff of the Tax Ombud. It was also not clear whether this meant that the Tax Ombud could identify individuals that the Tax Ombud sought to employ or whether the Tax Ombud could merely request suitable staff for a particular function and such staff is chosen by the Commissioner. Croome and Olivier[15] earlier commented that

> "[s]ome commentators have expressed unhappiness that former SARS officials will be seconded to the office of the Tax Ombud and that this undermines the independence of the tax Ombud. It is interesting to note that the Tax Ombud, Judge Ngoepe, when addressing a South African Institute of Tax Practitioner's function indicated that he would not merely accept any

[11] Bechard "The Tax Ombud's office is here to help" *Personal Finance* (16 July 2016) (http://www.iol.co.za/personal-finance/tax/the-tax-ombuds-office-is-there-to-help-2045992 (accessed 31 July 2017).

[12] par 2.49 of the Memorandum on the Objects of Tax Administration Laws Amendment Bill 2016 (http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2016-04%20-%20EM%20on%20the%20Tax%20Administration%20Laws%20Amendment%20Bill%20B18%20of%202016%2015%20December%202016.pdf (accessed 31 July 2017)).

[13] s 28 of the IGTA.

[14] s 6(2) of the South African Revenue Service Act 34 of 1997 ("SARS Act").

[15] Croome and Olivier *Tax Administration* (2015) 77.

> prospective employee offered by the Commissioner. Judge Ngoepe indicated that his office was also recruiting persons directly, and that not all of his office's employees were being seconded from SARS to reach the required staff levels to perform his functions under the TAA".

Potentially, the Commissioner could refuse to employ a person to be seconded to the office of the Tax Ombud if he considers that person not "suitable" to be in the office of the Tax Ombud, for whatever reason, including that the person is pro-taxpayers or anti-SARS. In his 2015/2016 Annual Report, the Tax Ombud stated that some of the challenges relating to the independence of the OTO were: the fact that the office of the Tax Ombud cannot employ its own staff, "it can only employ is staff through SARS; and that the fact that expenditure connected with the functions of the Office of the Tax Ombud is paid out of the funds of the SARS means no financial independence from the SARS".[16]

The TALAA amended the provisions relating to the appointment of the staff of the OTO. Section 15(1) the TAA currently provides that "[t]he Tax Ombud must appoint the staff of the office of the Tax Ombud who must be employed in terms of the SARS Act". The effect of this change is to remove the requirement of consultation with the Commissioner.

According to the Explanatory Memorandum the amendment aims to enhance the independence of the Tax Ombud in respect of the appointment of the staff of the Office of the Tax Ombud.[17] The staff of the OTO is no longer to be employed by the SARS and seconded to the OTO. The staff of the OTO will be appointed by the OTO directly. The employment of the staff of the OTO in terms of the SARS Act is solely to ensure that the staff of the OTO enjoy the same conditions of service as the staff of SARS. It is submitted that this amendment is of paramount importance to the independence (actual and perceived) of the OTO.

3.3 Finances of the OTO

In its original form, section 15(4) of the TAA provided that the "expenditure connected with the functions of the office of the Tax Ombud is paid out of the funds of SARS". The Commissioner for SARS is the accounting authority for SARS and is responsible for all income and expenditure of SARS, amongst other obligations related to finances.[18] Thus, all expenditure of SARS has to be approved by the Commissioner. This meant that the OTO needed an allocation of funds from the Commissioner in order for the OTO to be able to discharge its mandate, of investigating complaints against SARS. This is a direct form of financial dependence by the OTO on SARS as it meant that the Commissioner could either empower or disempower the OTO by under-allocating funds or inadequately financing the OTO, respectively. Croome and Olivier[19] suggest that the lack of budget allocation from Parliament is due to the fact that the allocation of funds from Parliament would have required a variety of statutory

[16] Tax Ombud 2015/2016 *Annual Report* 11.
[17] Memorandum on the Objects of Tax Administration Laws Amendment Bill (n 12) 45.
[18] s 9(3)(a) read with s 22 of the SARS Act.
[19] Croome and Olivier (n 15) 78.

amendments to give effect thereto, and that this should not undermine the credibility of the Tax Ombud's office – what is more important is the stature of the person appointed as Tax Ombud. The TALAA amended this funding provision to the effect that the expenditure connected with the functions of the office of the Tax Ombud is paid in accordance with a budget for the office approved by the Minister. As stated in the Explanatory Memorandum, this amendment directly impacts on and enhances the independence of the OTO.

3.4 Mandate of the Tax Ombud

The original provisions on the mandate of the Tax Ombud charged the Tax Ombud with the responsibility to review and address any complaint by a taxpayer regarding a service matter or a procedural or administrative matter arising from the application of the provisions of a tax Act by SARS. Thus action on the part of the Tax Ombud was triggered by, and only by, a complaint by a taxpayer. This was further emphasised in section 18 headed "Review of complaint" which states in subsection (1) that "[t]he Tax Ombud may review any issue within the Tax Ombud's mandate on receipt of a request from a taxpayer."

Section 51 of the TALAA extended the ambit of mandate of the Tax Ombud by commissioning the Tax Ombud to review, at the request of the Minister or at the initiative of the Tax Ombud with the approval of the Minister, any systemic and emerging issue related to a service matter or the application of the provisions of this Act or procedural or administrative provisions of a tax Act.[20]

Various observations can be made with regards to this provision. First, the Tax Ombud can now review at the initiative of the Tax Ombud systemic and emerging issues related to a service matter or the application of the provisions of the TAA or procedural or administrative provisions of a tax Act. This development transforms the OTO from being an organisation which was confined to a reactive role unable to initiate its own investigations to one that can proactively identify and red-flag certain trends and alert SARS. Such extension of powers would result in more accountability on the part of the OTO. However, the Tax Ombud is only empowered to undertake such review with the approval of the Minister. It is not indicated in the Explanatory Memorandum why this power is limited by approval from the Minister. Such limitation, it is submitted, is unnecessary and may lead to unnecessary delays in the carrying out of the mandate of the OTO due to the fact that ministerial approvals take time to obtain and systemic issues may have adverse and significant impact on taxpayers. The ministerial approval delays could dilute the proactivity of the reviews by the OTO because once these issues affect taxpayers and taxpayers raise these with the OTO, then ministerial approval is no longer required and the OTO may address the issue forthwith.

Secondly, the review powers of the OTO in this regard is of any systemic or emerging issue related to (1) a service matter; or (2) application of the provisions of the TAA; or (3) application of procedural provisions of a tax Act; or (4)

[20] s 16(1)(b) of the TAA.

application of administrative provisions of a tax Act.[21] Thus, the systemic or emerging issue that the OTO may review should relate only to those matters that the OTO originally had a mandate to review, following a complaint.

3.5 Resolutions and recommendations of the OTO

The TAA charges the Tax Ombud to attempt to resolve all issues within its mandate at the level at which they can most efficiently and effectively be resolved and must, in so doing, communicate with SARS officials identified by SARS.[22] One of the most concerning provisions regarding the effect of the recommendations of the Tax Ombud was that the TAA specifically stated that the recommendations of the Tax Ombud were not binding on a taxpayer or SARS. This effectively rendered the Tax Ombud's recommendations to be of no force or effect. The recommendations were no more significant than mere advice to SARS or taxpayers. Without granting any more force or effect to the recommendations of the Tax Ombud, section 52 of the TALAA places an obligation on the taxpayer or SARS to provide reasons should such recommendations be rejected by the taxpayer or SARS. The new provision states as follows:

> "The Tax Ombud's recommendations are not binding on a taxpayer or SARS, but if not accepted by a taxpayer or SARS, reasons for such decision must be provided to the Tax Ombud within 30 days of notification of the recommendations and may be included by the Tax Ombud in a report to the Minister or the Commissioner under section 19."

As can be seen from the above, it is not peremptory that the reasons for the rejection by SARS should be included in the report by the Tax Ombud. Furthermore, section 19 does not provide for the inclusion in the report of the OTO of the recommendations that have been rejected and the reasons thereof. The recommendation and the reasons for the rejection have to be included in the Tax Ombud's report if that recommendation and reasons for rejection relate to one of the most serious issues encountered by taxpayers or identified a systematic and/or emerging issue. This would be so if in the year to which the report relates fewer than nine other serious issues were encountered.

An investigation by the Tax Ombud of a matter is a serious issue. The decision by a judge to investigate and have recommendations made thereby rejected is a serious matter that must be reported to the Commissioner and/or the Minister. It is recommended that a separate list of at least ten of the most serious recommendations that have been rejected and reasons thereof should be brought to the attention of the Minister through the Tax Ombud's report. This would help focus the attention of the OTO to interactions between the OTO and taxpayers, as well as creating control and visibility and transparency, that would ease the balance of power between SARS and taxpayers.

[21] s 16(1)(b) of the TAA as added by the substitution of subsection (1) of s 16 of the TAA by s 51 of the TALAA.

[22] s 20(1) of the TAA.

The TAA also does not provide for any action to be taken by any party be it the Tax Ombud, the Minister, Commissioner or the aggrieved party against the non-acceptance of the recommendations of the Tax Ombud.

The powers of the Australian IGT are on level pegging with the powers of the Tax Ombud and aligns to the purpose of the IGT. In terms of section 3 of the Australian IGTA the purpose of the IGT are to: (a) improve the administration of the tax laws for the benefit of all taxpayers; (b) provide independent advice to the government on the administration of the tax laws; and (c) identify systemic issues in the administration of the tax laws. Thus, the overall aim of the IGT is to improve the administration of taxation laws for the benefit of all taxpayers, tax practitioners and other entities.[23]

The functions of the Australian IGT are limited to review systems established by the ATO to administer the tax laws, including systems for dealing or communicating with the public generally, or with particular people or organisations, in relation to the administration of the tax laws[24] and systems established by tax laws, but only to the extent that the systems deal with administrative matters.[25] Once the reviews are done, the IGT is obligated to report on those reviews, setting out the subject and outcome of the review.[26] Of particular interest in this regard is that the IGT is obligated to report on any recommendations that the InspectorGeneral thinks appropriate concerning how the system reviewed could be improved.[27] Thus the IGT cannot direct the Commissioner of Taxation to take any particular action in respect of a taxpayer. In a paper presented at the International Taxpayer Conference in Washington DC on 19 November 2015 the IGT, Ali Noroozi, argues that although the IGT cannot direct the Commissioner of Taxation to take any particular action in respect of a taxpayer, the engagement of the IGT with complainants and the ATO has been beneficial in identifying key issues and options for resolution.[28]

In the USA, section 7803(c)(2)(B)(ii) of the Internal Revenue Code ("IRC") requires the National Taxpayer Advocate ("NTA") to report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on the objectives of the Office of the Taxpayer Advocate for the fiscal year beginning in such calendar year. Any such report shall contain full and substantive analysis, in addition to statistical information.[29] The NTA annually reports to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on the activities of the Office of the Taxpayer Advocate during the fiscal year ending during such calendar year.[30] The reports contain full and substantive analysis, in addition to statistical information. The reports are required to:

[23] s 3 of the IGTA.
[24] s 7(1)(a)(i) of the IGTA.
[25] s 7(1)(a)(ii) of the IGTA.
[26] s 7(1)(b)(i) of the IGTA.
[27] s 7(1)(b)(ii) of the IGTA.
[28] Noroozi (n 6).
[29] s 7803(c)(2)(B)(i) of the IRC.
[30] s 7803(c)(2)(B)(ii) of the IRC.

- identify the initiatives the Office of the Taxpayer Advocate has taken on improving taxpayer services and Internal Revenue Service responsiveness;
- contain recommendations received from individuals with the authority to issue Taxpayer Assistance Orders;
- contain a summary of at least 20 of the most serious problems encountered by taxpayers, including a description of the nature of such problems;
- contain an inventory of the above items for which
  - action has been taken and the result of such action;
  - action remains to be completed and the period during which each item has remained on such inventory; and
  - no action has been taken, the period during which each item has remained on such inventory, the reasons for the inaction, and identify any Internal Revenue Service official who is responsible for such inaction;
- identify any Taxpayer Assistance Order which was not honored by the Internal Revenue Service in a timely manner;
- contain recommendations for such administrative and legislative action as may be appropriate to resolve problems encountered by taxpayers;
- identify areas of the tax law that impose significant compliance burdens on taxpayers or the Internal Revenue Service, including specific recommendations for remedying these problems;
- identify the 10 most litigated issues for each category of taxpayers, including recommendations for mitigating such disputes; and
- include such other information as the National Taxpayer Advocate may deem advisable.

The Commissioner is required to establish procedures requiring a formal response to all recommendations submitted to the Commissioner by the NTA within three months after submission to the Commissioner.

The NTA may issue Taxpayers Assistance Orders ("TAOs") where a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the IRS.[31] Significant hardship is defined to include economic burden, systemic burden, impairment of rights or serious privation (more than mere economic or personal inconvenience).[32] The TAO may require the Secretary of the Treasury within a specified time period to release property of the taxpayer levied upon (*ie* attached by the IRS), or cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer (with respect to collection, bankruptcy and receiverships, discovery of liability and enforcement of title), or any other provision of law which is specifically described by the NTA in such order.[33]

[31] s 7811(a)(1) of the IRC.
[32] s 7811(a)(2) of the IRC and Treas Reg § 301.7811-1(a)(4)(ii).
[33] s 7811(b)(1) and (2) of the IRC.

Any TAO issued by the NTA may be modified or rescinded by the NTA, the Commissioner of Internal Revenue, or the Deputy Commissioner of Internal Revenue, and only if a written explanation of the reasons for the modification or rescission is provided to the NTA.[34] The NTA may also issue a Taxpayer Advocate Directive in order to mandate administrative or procedural changes to improve the operation of a functional process, or grant relief to groups of taxpayers (or all taxpayers) when its implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.[35]

In this regard, the Mexican PRODECON has far reaching powers of enforcement in relation to its recommendations. PRODECON is empowered to impose penalties on the Mexican federal tax authorities in cases where the tax authority fails to state its position regarding recommendations issued by PRODECON, or refuses to achieve a recommendation addressed by PRODECON on an act declared void by complete lack of legal basis.[36] Other specific cases where PRODECON may impose penalties are cases where the tax authorities fail to provide supporting evidence in a complaint procedure.[37] The penalties imposed by PRODECON may be economical or administrative in nature.[38]

As can be seen, the Australian IGT has limited powers of enforcement, similar to the current South African Tax Ombud. The American NTA's powers are a bit more elaborate and necessitate a level of accountability on the part of the NTA. The Mexican PRODECON on the other hand has superior powers of enforcement. It is submitted that without such powers as conferred on PRODECON, the Tax Ombud's relevance and importance will remain limited to the extent of challenging and defying the Tax Ombud's credibility.

4 *Conclusion*

The OTO was created to deal with problems of an administrative nature between SARS and taxpayers as well as to provide taxpayers with a low cost mechanism to address administrative difficulties that cannot be resolved by SARS. The responsibility of the OTO is to provide easily available remedies to taxpayers where taxpayers have been aggrieved by SARS administrative processes.

Whilst it is acknowledged that the changes made to the OTO in 2017 have the desired effect of enhancing the powers of the OTO in achieving this goal, it goes without saying that elsewhere, similar offices have developed much more powers and authority. Their development gives them more relevance and effect

[34] s 7811(c) of the IRC.
[35] Delegation Order 13-3 (formerly DO-250, Rev 1), *Authority to Issue Taxpayer Advocate Directives* (17 Jan 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives* (16 July 2009).
[36] International Tax Review "Mexican Taxpayer's Ombudsman – mediator empowerment" (2015) (http://www.internationaltaxreview.com/Article/3430272/Mexican-Taxpayers-OmbudsmanMediator-empowerment.html (accessed 24 August 2017)).
[37] *supra*.
[38] *supra*.

to deal with the increased complexity of the relationship between tax authorities and taxpayers. The emergence of taxpayers' rights and the enforceability thereof may not be of effective value without firmly developed, efficient and most importantly powerful tax ombuds or similar institutions. Based on the aforegoing, it is unimaginable that the limited powers granted by legislation to the OTO would achieve the objectives of the OTO in the fast-developing world.

With the introduction of more tax instruments,[39] the development of other rules,[40] the enhancement of the tax administration[41] as well as disclosure programmes,[42] the South African tax system has become much more complex and that translates to the relationship between the SARS and the taxpayers being much more complicated. There are more and more issues that are bound to exist in this relationship that would not have existed before (or at least at the same level). Furthermore, the relationships between the taxpayers and SARS go beyond the understanding of the South African tax laws. In cross-border transactions, varied tax instruments come into play, for example where taxpayers are subject to tax in a foreign jurisdiction, and such exposure to tax has relevance to their tax liability in South Africa.

It is clear that in comparison to the countries explored the South African OTO is granted the least powers in protection of taxpayers' entitlements in relation to SARS. The Mexican PRODECON is currently the most efficient of the compared institutions. It is therefore submitted that in order to enhance the efficiency, utility, expediency and suitability of the OTO to taxpayers, and thereby creating and maintaining the credibility required for taxpayers to procure the services of the OTO when required, the powers of the OTO need to be enhanced to cover at least the ability to have the OTO's recommendations enforceable. Without legal force the recommendations of the OTO remain that, recommendations that could be accepted or rejected by SARS. This creates an imbalance because if the recommendation is against the taxpayer, SARS is able to apply those in collection mechanisms, for example "pay now argue later", while if the recommendation is against the SARS the taxpayer may only resort to legal processes, that are notoriously lengthy and expensive, thereby defeating the purpose of the OTO.

The OTO needs powers to represent taxpayers in legal processes against SARS. At the very least this is because SARS's resources place SARS at a disproportionate advantage against taxpayers who seek to protect themselves and property (mainly revenue) against undue deprivation. To have the taxpayer use the very revenue that the taxpayer needs to protect, mainly creates a dilemma for the taxpayer to make payments even when those payments are not due, in order to protect their current and future revenues. This is also often influenced by the need of taxpayers to work towards creating or enhancing future revenue

[39] *eg* the withholding tax on interest, limitation of interest deductions and the rules relating to the accrual and incurral on interest.
[40] *eg* the change from the secondary tax on companies to the dividends tax.
[41] *eg* the introduction of the Tax Administration Act of 2011.
[42] *eg* the voluntary disclosure programme as well as reportable arrangements provisions.

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streams as opposed to spending the energy, money and time in defending current capital. The creation of this power is at the core of the function of the OTO, that is "to provide taxpayers with a low-cost mechanism to address administrative difficulties that cannot be resolved by SARS".

The National Credit Act 34 of 2005 and its impact on set-off

CORLIA VAN HEERDEN*

1 *Introduction*

With the coming into operation of the National Credit Act 34 of 2005 (hereinafter NCA), South Africa has witnessed the birth of a new post-constitutional[1] credit landscape that seeks to provide greater inclusion to previously disadvantaged persons and greater protection to credit consumers in general. Collectively the NCA aims to address the injustices perpetrated under the previous pre-constitutional dispensation and to balance the rights of consumers and credit providers because such balance is essential to a well-functioning credit market. Achieving such balance is necessary for more than the obvious reason that South African credit consumers were desperately in need of better access to credit and better protection in the credit market. However, these considerations are not the only ones that can inform the objectives of credit legislation. It is also very important to consider what would be the optimal amount of consumer protection to dispense without compromising the sustainability of the credit market. If the rights of consumers and credit providers are not balanced and unjustifiably skewed in favour of the consumer the regulatory barriers erected by the NCA will distort the ability of credit providers to continue the high-risk business of providing credit, an event that might see some credit providers exiting the credit market and by doing so, leaving behind a more concentrated market where access to credit is significantly impeded. Even worse, it may open up lucrative opportunities and perverse incentives for unscrupulous loan sharks who operate below the regulatory radar. Also, where regulatory intervention causes greater regulatory compliance by credit providers it can have the undesired consequence that these costs are eventually filtered through to consumers and in this sense access to credit is also impeded by the high cost of credit occasioned by such regulatory compliance.[2]

The NCA, in its attempt to balance the rights of consumers and credit providers, has curtailed many rights that credit providers previously had under

* BProc LLB LLM LLD. Barclays Africa Chair in Banking Law in Africa, Professor, Department of Mercantile Law, University of Pretoria.

[1] South Africa adopted a Constitution upon moving towards a democratic regime in 1994. The Constitution of the Republic of South Africa, 1996, contains a Bill of Rights in Chapter 2 which entrenches several fundamental human rights.

[2] See *Sebola v Standard Bank of South Africa Ltd* 2012 (5) SA 142 (CC) par 75 where Cameron J remarked that extra costs occasioned by regulatory compliance is "a social burden" imposed by a legislative scheme that wants to give consumers a last chance before court enforcement procedures drop the "guillotine" on them.

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the previous credit dispensation facilitated by the Credit Agreements Act and the Usury Act.[3] An example in point is the statutory *ultra duplum* rule as contained in section 103(5), which allows for the protection of the consumer to kick in at a much earlier stage than under the common-law *in duplum* rule.[4] Another example is the extensive and novel debt relief provided to consumers by means of the provisions in Part D of Chapter 4 of the Act that relate to reckless credit and over-indebtedness.[5] It is not only on a substantive level that the consumer has been afforded better protection by the NCA. The Act notoriously places various procedural hurdles in the way of a credit provider who seeks to enforce a credit agreement and as such it elevates the use of procedure as a significant consumer protection mechanism.[6]

It appears that also in the context of set-off, the NCA has curtailed the rights of credit providers. The purpose of this contribution is therefore to consider the provisions in the NCA regarding set-off of debts, its impact on the common-law right of set-off and its implications for consumers and credit providers. This contribution will be limited to a consideration of the situation where an amount of money in an account that a consumer holds with a bank is appropriated to cure the arrears on a credit agreement (governed by the NCA) that the consumer has with the same bank as credit provider. For purposes of this contribution the words "debtor", "customer" and "consumer" will be used interchangeably and the words "bank" and "credit provider" will also be used interchangeably.

2 *Set-off*

2.1 Set-off in terms of the common law

Set-off is a method of debt settlement, emanating from the common law, by which obligations, whether arising contractually or otherwise, can be terminated without requiring the exchange of performances by the parties.[7] Set-off operates

[3] 75 of 1980 and 73 of 1968 respectively.

[4] See Kelly-Louw "The common-law versus the statutory in duplum Rule" 2006 *Juta's Business Law* 141; Kelly-Louw "Better consumer protection under the statutory in duplum rule" 2007 *SA Merc LJ* 337; Friedman and Otto "Section 103(5) of the National Credit Act 34 of 2005 as inspired by the common-law in duplum rule (1)" 2013 *THRHR* 132 and Friedman and Otto "Section 103(5) of the National Credit Act 34 of 2005 as inspired by the common-law in duplum rule (2)" 2013 *THRHR* 361.

[5] See Van Heerden in Scholtz *et al Guide to the National Credit Act* (2008 *et seq*) ch 11 for a detailed overview of the provisions of the NCA relating to reckless credit and over-indebtedness.

[6] See Van Heerden (n 5) par 12.1.

[7] Van der Merwe *et al Contract – General Principles* (2012) 469; Christie and Bradfield *Christie's The Law of Contract in South Africa* (2011) 494; *Joint Mutual Pension Fund (Transvaal) v Pretoria Municipal Pension Fund* 1969 2 SA 78 (T) 85C. For a detailed and critical overview of the development of set-off see Van Deventer *Set-Off in South African Law: Challenges and Opportunities* (2016 LLM dissertation US). See also Van Deventer "The enforcement of credit agreements through set-off: Evaluating the impact of the National Credit Act 34 of 2005" 2017 *SALJ* 415, a journal contribution by Van Deventer that is largely based on the discussion in her dissertation of common-law set-off and how the NCA has impacted on common-law set-off.

when two parties are mutually (reciprocally) indebted to each other[8] and the mechanism of set-off extinguishes these mutual obligations as effectively as if they had been discharged by performance.[9] If the debts are for the same amount, both are extinguished; if not the smaller debt is extinguished whilst the larger debt is reduced by the amount of the smaller debt. [10] The mechanism of set-off was developed to avoid back and forth payments between parties who are both indebted to each other.[11]

Van Deventer points out that set-off is a valuable commercial tool that is especially attractive in the banking sector by virtue of the simplification, efficiency and security that it offers.[12] In essence set-off is a convenient method of effecting performance as it makes it unnecessary for one party to pay another only to have the same performance returned.[13] It thus avoids the circuity of performance and enhances efficiency[14] by facilitating the speedy settlement of debts and eliminating the need for costly duplication of performance.[15]

Van Deventer further points out that set-off also performs a security function by allowing a creditor to enforce fulfilment of the debtor's obligations, even in circumstances where such fulfilment would otherwise be difficult or even impossible to enforce. As such a creditor of an insolvent debtor, who was able to invoke set-off before *concursus creditorum*, is allowed to rely on set-off, provided such set-off meets the requirements of section 46 of the Insolvency Act.[16]

The useful mechanism of set-off serves to effect a "fair outcome" in the following ways:[17]

[8] Van der Merwe (n 7) 469; Van Deventer (n 7 (2016)) 1 and 35. Thus each party is both a debtor and creditor of the other. Accordingly, a party who acts in a representative capacity cannot raise set-off. See Van der Merwe (n 7) 470; *Exley v Exley* 1952 (1) SA 644 (O); *Strachan v The Master* 1963 (2) SA 620 (N); *The Government v Regna-Adwel Business Machines Africa (Pty) Ltd* 1970 (2) SA 428 (T).

[9] Van der Merwe (n 7) 475.

[10] Van Deventer (n 7 (2016)) 1.

[11] *Ibid*.

[12] Fountoulakis *Set-Off Defences in International Commercial Arbitration: A Comparative Analysis* (2011) 12; Van Deventer (n 7 (2016)) 5.

[13] Joubert *General Principles of the Law of Contract* (1987) 286; Van Deventer (n 7 (2016)) 6.

[14] Fountoulakis (n 12) 1.

[15] Van der Merwe (n 7) 469-470; Van Deventer (n 7 (2016)) 6.

[16] 24 of 1936; Van Deventer (n 7 (2016)) 7. S 46 of the Insolvency Act provides: "If two persons have entered into a transaction the result whereof is a set-off, wholly or in part, of debts which they owe one another and the estate of one of them is sequestrated within a period of six months after the taking place of the set-off, or if a person who had a claim against another person (hereinafter in this section referred to as the debtor) has ceded that claim to a third person against whom the debtor had a claim at the time of cession, with the result that the claim had been set-off, wholly or in part, against the other, and within one year after the cession the estate of the debtor is sequestrated; then the trustee of the sequestrated estate may in either case abide by the set-off or he may, if the set-off was not effected in the ordinary course of business, with the approval of the Master disregard it and call upon the person concerned to pay the estate the debt which he would owe it but for the set-off, and thereupon that person shall be obliged to pay that debt and may prove his claim against the estate as if no set-off had taken place: Provided that any set-off shall be effective and binding on the trustee of the insolvent estate if it takes place between an exchange or a market participant as defined in section 35A and any other party in accordance with the rules of such an exchange, or if it takes place under an agreement defined in section 35B."

[17] Van Deventer (n 7 (2016)) 7.

(a) It provides a defence to a debtor against a claim from his creditor while the debtor has a counterclaim against the creditor.

(b) It enables the creditor to enforce an obligation that is due but which the debtor is unable or unwilling to fulfil and as such it constitutes a reliable method of debt collection.

(c) Set–off can be utilized where a debtor does not have the financial means to pay his debt but can fulfil his obligations by way of set-off. As such set-off prevents the debtor from defaulting on his payment obligations and thus suffering the consequences of breach such as the cancellation of the contract or the invocation of an acceleration clause.

The requirements for set-off to operate are:[18] the debts must exist between the same parties in the same capacities; the debts must be capable of set-off, such as monetary debts (it is also possible to apply set-off to non-monetary debts as long as these debts are of the same class and quality);[19] set-off will not be allowed where the debts are illegal, for example where there is a common-law or statutory prohibition against set-off or if it is contrary to public policy; both debts must be due and payable and thus enforceable and the debts must be liquidated. Set-off will, however, not operate where it is contractually excluded.[20]

Set off may also be relied upon in circumstances other than between the original debtor and his creditor. As such a surety may rely on set-off between the principal debtor and creditor.[21] A debtor can also rely on set-off against a cedent if set-off was possible before the cession.[22]

Van Deventer remarks that it is generally understood that the question in South African law of whether set-off operates *ipso iure* or retrospectively, was answered in favour of the *ipso iure* approach by the Appellate Division in *Schierhout v Union Government (Minister of Justice)*.[23]

2.2. The impact of the National Credit Act on set-off

As pointed out above, set-off is an extremely useful mechanism employed especially by banks. It must of course be appreciated that banks are in the fortunate position that the bank-customer relationship is essentially a mutual debtor–creditor relationship which entitles the bank to appropriate a credit balance in its customer's account by setting it off against another indebtedness

[18] Van Deventer (n 7 (2016)) 35-41.
[19] Van Deventer mentions the example of the same type and grade of grain.
[20] Van Deventer (n 7 (2016)) 41.
[21] Van der Merwe (n 7) 470-471.
[22] Van der Merwe (n 7) 470, 475.
[23] 1926 AD 286. It was held that "[w]hen two parties are mutually indebted to each other, both debts being liquidated and fully due, then the doctrine of compensation comes into operation. The one debt extinguishes the other *pro tanto* as effectually as if payment had been made. Should one of the creditors seek thereafter to enforce his claim, the defendant would have to set-up the defence of *compensatio* by bringing the facts to the notice of the Court – as indeed the defence of payment would also have to be pleaded and proved. But, compensation once established, the claim would be regarded as extinguished from the moment the mutual debts were in existence together." Van Deventer however points out that the issue whether set-off applies automatically is problematic and very competently probes this issue ((n 7 (2016)) 42-86). A discussion of whether set-off should operate automatically or not is however beyond the scope of this contribution, for purposes of which it is accepted that set-off operates *ipso iure*.

that the customer owes to the bank.[24] As pointed out by Van Deventer a bank will often insert a "cross-default clause" in a loan agreement with its customer, allowing the bank, in the event of default by the customer, to utilise funds held by the bank in another account of the customer, in order to satisfy the outstanding loan payment.[25]

Set-off is not only a useful commercial tool but is also a powerful mechanism in the hands of a bank.[26] It is submitted that generally banks who apply set-off will not inquire as to the purpose of the money, which is deposited into an account that the bank wishes to utilise for purposes of setting off a debt that the customer owes the bank in respect of another account. Thus the bank will not for instance consider that the customer may need to spend the money on maintaining himself and his family.

The NCA however appears to have changed the right of the bank as credit provider to apply common-law set-off without notification and without complying with any "formalities". Section 90(2)(n) and section 124 of the NCA deal with set-off. Section 90 of the NCA sets out which provisions, if they appear in credit agreements governed by the Act, would constitute unlawful provisions for purposes of the Act. In this regard section 90(2)(n) provides that a provision in a credit agreement is unlawful if

> "it purports to authorize or permit the credit provider to satisfy an obligation of the consumer by making a charge against an asset, account, or amount deposited by or for the benefit of the consumer and held by a credit provider or a third party, except by way of a standing debt arrangement, or to the extent permitted by section 124."

Section 124 is entitled "Charges to other accounts" and provides as follows:

"(1) It is lawful for a consumer to provide, a credit provider to request or a credit agreement to include an authorization to the credit provider to make a charge or series of charges contemplated in section 90(2)(n), if such authorization meets *all*[27] the following conditions-

- (a) The charge or series of charges may be made only against an asset, account or amount that has been-
  - (i) deposited by or for the benefit of the consumer and held by that credit provider or that third party; and
  - (ii) specifically named by the consumer in the authorization;
- (b) the charge or series of charges may only be made to satisfy-
  - (i) a single obligation under the credit agreement; or
  - (ii) a series of recurring obligations under the credit agreement, specifically set out in the authorization;
- (c) the charge or series of charges may be made only for an amount that is-
  - (i) calculated by reference to the obligation it is intended to satisfy under the credit agreement, and
  - (ii) specifically set out in the authorization;
- (d) the charge or series of charges may be made only on or after a specified date, or series of specified dates-

[24] *Absa Bank Ltd v Intensive Air (Pty) Ltd* 2011 (2) SA 275 (SCA); Van Deventer (n 7 (2016)) 115-116. See also Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 152-156.
[25] Van Deventer (n 7 (2016)) 114.
[26] Van Deventer (n 7 (2016)) 123.
[27] Author's emphasis.

(i) corresponding to the date on which an obligation arises, or the dates on which a series of recurrent obligations arise, under the credit agreement; and

(ii) specifically set out in the authorization; and

(e) any authorization not given in writing, must be recorded electromagnetically and subsequently reduced to writing.

(2) Before making a single charge, or the initial charge of a series of charges, to be made under a particular authorization, the credit provider must give the consumer notice in the prescribed manner and form, setting out the particulars as required by this subsection, of the charge or series of charges to be made under that authorization."[28]

The concept "charge" is not defined in the NCA but Van Deventer points out that it is mainly used as the equivalent of costs or fees and that it is widely accepted that "charge" should be afforded a wide interpretation.[29] Accordingly she states that "charge" as per section 90(2)(n) and section 124 thus refers to appropriation or withdrawal of funds from an account[30] – as is done when set-off is effected.

Van Deventer points out that sections 90(2)(n) and 124 of the NCA make no reference to and contain no express variation of the common-law right to set-off and further points out that

> "the legislature is presumed to be acquainted with the state of the law, including the common law. The common law can be amended by statutory provisions but these provisions should not be interpreted to alter the common law more than necessary. For the common law to be varied, the intention of the legislature must be plainly aimed at modifying the common law, and even in such a case the modification will only be to the extent provided for by the relevant statutory provisions (whether expressly or by necessary implication)".[31]

It is indeed so that neither section 90(2)(n) nor section 124 refers expressly to the common law right to set-off. However, it is submitted that it is necessarily implied by section 90(2)(n) read with section 124 that the legislature intended to specifically regulate the application of the principles of set-off in the context of credit agreements governed by the NCA and as such intended to provide for statutory set-off as opposed to not regulating the aspect of set-off at all and allowing the principles of common-law set-off to apply by default. This is also in line with the canon of interpretation that the legislature does not intend meaningless legislation. On the face of it one can thus assume that the legislature intended the provisions of section 124 to supersede common-law set-off. Arguably this attempt to regulate set-off is not necessarily the clearest piece of legislative drafting that one will ever see. However, it is submitted that the implied tenor of section 124 is that if a bank wants to effect set-off in circumstances where the NCA applies, such set-off has to conform with section 124. As discussed below in paragraph 4, banks that are seeking to rely on their right to continue to apply the common-law right of set-off in this context rely

[28] S 124(3) further provides that if there is a conflict between the provisions of s 124 and a provision of the National Payment Systems Act 78 of 1998, then the provisions of the National Payment Systems Act prevail.

[29] Van Deventer (n 7 (2016)) 115.

[30] Van Deventer (n 7 (2016)) 117.

[31] Van Deventer (n 7 (2016)) 122.

heavily on the wording of section 90(2)(n) which refers to a set-off provision in a credit agreement that will be unlawful if it does not meet the requirements of section 124. Otto and Otto remark with regard to section 90(2)(n) and section 124, that "[w]hat is clearly prohibited is a clause in a contract which generally authorises the credit provider to satisfy a debt out of any account the consumer has with it."[32] It is submitted that indeed section 90(2)(n) prohibits such a provision in a contract but one cannot just rely on section 90(2)(n) and read no further. It is further submitted that section 124 sets out how the legislature intends set-off to work in terms of the NCA and the operation of section 124 is not dependent on section 90(2)(n). It is conceded that section 124 may be worded in a confusing manner by indicating that it will be lawful to include an authorization that meets all the requirements of the said section in a credit agreement but it is submitted that what section 124 actually seeks to achieve is to dictate the requirements for set-off in the context of a credit agreement governed by the NCA, because why else would the legislature have gone to the length of drafting such an elaborate provision complete with accompanying regulation and form, as indicated below, if the intention was not that credit providers should abide by it?

The statutory set-off introduced by section 124 is notably complex and imposes a variety of obligations on the credit provider. The first aspect to be noted is that a provision in a credit agreement allowing for set-off to be effected other than as provided for in section 124, except by way of a standing debt arrangement, will be unlawful. Thus, for set-off to be lawfully effected by means of a charge against the account of a consumer where that specific account has a credit balance but the debtor otherwise owes money to the credit provider in respect of another account relating to a credit agreement that is in default, it will be necessary for the credit provider to comply with the requirements of section 124. From the wording of section 124 it is clear that a credit provider will be able to insert a clause (authorization) into a credit agreement in which the consumer agrees to the credit provider making a charge (and thus effecting set-off) against another account (or accounts) that the consumer has with that credit provider. Such authorization can however not be a mere blanket statement that the consumer agrees to the application of set-off by the credit provider being allowed to take money from his other accounts to set off the debt on the account where the consumer is in default.[33]

It is expressly provided that any provision in a credit agreement that intends to provide for the credit provider to use the mechanism of set-off to apply funds in one account that the debtor has with the credit provider in order to effect payment in respect of another account will have to meet *all*, and not only some, of the requirements set by section 124. The application of statutory set-off as provided for by section 124 has to be captured in a written authorisation which points to the intention of the legislature not to allow for unwritten, *ipso iure* set-off facilitated by the common law. As such statutory set-off can only be applied

[32] Otto and Otto *The National Credit Act Explained* (2016) 60 n 63.
[33] See also Van Deventer (n 7 (2016)) 114.

where an amount has been deposited for the benefit of the consumer and will not apply to amounts deposited in the consumer's account that belongs to, or has been deposited for the benefit of a third party. It is trite that amounts that do not belong to the debtor should not be susceptible to set-off and in principle this provision does not appear problematic.[34] In addition, section 124 only allows set-off in respect of assets, accounts or amounts specifically named in the authorization. This presupposes a written pre-authorization that specifically mentions that set-off can be levied against a specific asset or specific amounts deposited by the consumer or that it may only be applied to accounts specifically mentioned in the authorization. One wonders what extent of specificity the legislature had in mind: it will often be impossible for a bank, at the time of entering into a bank-customer agreement or otherwise entering into a credit agreement with a consumer, to conceive of all the assets, amount or accounts of a consumer that may be able to be utilised for purposes of set-off – especially if one considers that such customer may at later stages enter into more agreements and credit agreements with the same bank. For example, a customer who has his current account with a bank and enters into a mortgage agreement with the bank as credit provider may later enter into one or more personal loans and vehicle financing agreements with the same bank. Does section 124(1)(a) mean that the authorization in terms of section 124 that is included in the credit agreement will only be able to allow for set-off against other accounts that the consumer at that stage has with the credit provider (*ie* that is in existence at the time of entering into the agreement in which the authorization is contained) and that such accounts must be mentioned in detail (*ie* specifically) such as, for example, "current account number 123456ABC"?

The scope of the opportunity to apply the statutory set-off mechanism as envisaged by section 124 is further narrowed by section 124(b) that allows any set-off charge or series of set-off charges to be effected only to satisfy a single obligation under the credit agreement or a series of recurring obligations under the credit agreement, and only if such obligations or recurring obligations are specifically set out in the credit agreement. One may ask how the legislature envisaged this requirement to be met and whether it will suffice for purposes of specificity to state in the authorization that the obligation to which set-off applies is the instalment or instalments (being a series of obligations) due under the credit agreement in which the authorization is contained should such instalments be in default.

Section 124(c) states that the set-off charge or series of charges may only be made for an amount that is calculated by reference to the obligation it is intended to satisfy under the credit agreement. This amount has to be specifically set out in the authorization, failing which the requirement of section 124(c) will not be met and the application of statutory set-off will be barred. Does this mean that the authorization must state, for example, that a charge for R5000 being the amount of one instalment or multiples of R5000 (depending on the number or

[34] *ABSA Bank Ltd v Intensive Air (Pty) Ltd* 2011 (2) SA 275 (SCA).

"series" of obligations that are in arrears) may be made given that the agreed amount of monthly instalments due in a credit agreement will be reflected in the said credit agreement and will be certain at least where it is a fixed rate credit agreement? What would then be the position regarding a credit agreement that is not subject to a fixed rate?

The time at which the set-off may be effected should also correspond with the requirements of section 124(d), which in essence means that set-off can only be effected once the debt (or series of recurring debts) owing by the debtor is due and owing. Notably these specified dates are also required to be set out in the authorization. Does this mean that the specific dates that each and every instalment due in terms of the credit agreement must be specifically mentioned in the credit agreement just to cover all bases should the debtor default with one of these payments?

The authorization that should meet all the requirements as stated in section 124(a) to (e) is however not by itself sufficient to facilitate lawful set-off. This is because section 124(2) requires such set-off to also be preceded by a notice to the consumer that sets out the particulars of the charge or charges that will be made. Such notice has to be in the prescribed manner and form. In this regard regulation 38 provides that:[35]

> "A notice to a consumer of a charge or series of charges to be made to another account as contemplated in section 124(2) of the Act must be given to the consumer in Form 27 *before* the charge or first charge will be made, or must be recorded electromagnetically, transcribed and delivered to the consumer and must include the following information:[36]
>
> (a) a reference to the written direction by the consumer authorising the charge or series of charges, as contemplated in sections 124(1) and 90(2)(n) of the Act;
>
> (b) the account against which the charge or series of charges will be made;
>
> (c) the obligation that the charge or series of charges is intended to satisfy;
>
> (d) the account to which that obligation relates;
>
> (e) whether the charge is a single charge or a series of charges;
>
> (f) the amount or amounts of the charge, and the method of calculation; and
>
> (g) the date on which the charge or first charge in the series will be effected.

Form 27 bears the heading "Notice of charges or series of charges levied in terms of section 124(2) of the National Credit Act 34 of 2005". It *inter alia* requires the credit provider to set out the detail as indicated by regulation 38.

Although rather onerous, credit providers may be able to insert an authorization into a credit agreement that meets the requirements of section 124 and as such the authorization itself should not pose too many problems except that it may arguably not cover future accounts that the consumer subsequently takes on with the credit provider. The bigger problem from a credit provider's perspective however appears to be the requirement that the credit provider must give the consumer advance notice that set-off will be effected. Such advance

[35] Reg 38 of the National Credit Act Regulations published under GN R489 in *GG* 28864 of 31 May 2006 as amended by GN R1029 of 30 Nov 2006.

[36] Author's emphasis.

notice was never required by the common law and one can imagine that in various instances consumers who get such a notice may withdraw the money in the account against which the credit provider intends to levy the set-off charge or move it to another account not covered by the authorization, thus leaving the credit provider unable to apply the mechanism of set-off. It is also not clear how long in advance the consumer should be given notice as per Form 27 read with regulation 38 and exactly how this notice has to be given to the consumer. Seeing that section 124 does not set out how the notice must be given save to indicate that it must be in the prescribed manner and form it is arguable that clearly the notice has to be delivered to the consumer and as section 124 does not indicate the mode of delivery the general provisions of section 65(2) will find application.[37] It may even be argued that given the seriousness of the notice it should at least be sent by registered post to the correct post office as per *Sebola v Standard Bank of South Africa Ltd*[38] and *Kubyana v Standard Bank of South Africa Ltd.*[39] Also, if it becomes clear that the creditor did not give (or maybe even if the debtor did not receive) the notice prior to the charge effecting set-off having been made it appears that the set-off could not validly have been effected and it raises the question whether the credit provider is then obliged to reverse the set-off. It may also be asked whether the debtor who receives a Form 27 notice can object to it and so prevent the money in the designated account from being appropriated towards payment of another account. Actually such aspect may not even be pertinent given that the debtor, if he acts swiftly enough upon receiving the Form 27 notice, would be free to move the money from the designated account and so thwart the credit provider's attempt at set-off. This appears to be quite possible given that there is nothing in the NCA that indicates that the credit provider is entitled *suo motu* to "freeze" the amounts in the account against which the charge may be made once the debtor is in default with payments in terms of the relevant credit agreement.

It is thus clear that statutory set-off as envisaged by section 124 of the NCA is far more onerous than common-law set-off that operates *ipso iure* without the constraining requirements of written authorization and prior notification.[40] One

[37] S 65(1) states that every document that is required to be delivered to a consumer in terms of the NCA must be delivered in the prescribed manner, if any. If no method has been prescribed for the delivery of a particular document to a consumer, s 65(2) indicates that the person required to deliver such document must "(a) make the document available to the consumer through one or more of the following mechanisms- (i) in person at the business premises of the credit provider, or at any other location designated by the consumer but at the consumer's expense, or by ordinary mail; (ii) by fax; (iii) by email; or (iv) by printable web-page; and (b) deliver it to the consumer in the manner chosen by the consumer from the options made available in terms of paragraph (a)."

[38] 2012 (5) SA 142 (CC).

[39] 2014 ZACC 1.

[40] Van Deventer (n 7 (2016)) 119 aptly remarks: "It is undoubtedly more preferable for a bank to rely on its more flexible common-law right to set-off, in terms of which the bank requires no authorisation and is not restricted in respect of the date, the specific account or the amount it may appropriate (although only amounts which are due and payable are susceptible to set-off). This also avoids the risk for instance of the client nominating one account in terms of section 124, but later instructing his employer to deposit his salary in another account held by him. If this happens the bank will have to obtain another section 124 authorisation in respect of the second account."

may ask why the legislature has complicated the application of the mechanism of set-off in the context of credit agreements governed by the NCA to the extent provided for in section 124. As indicated by Van Deventer the objective of the legislature pertaining to set-off is not addressed at all in any of the explanatory and policy documents dealing with the rationale behind the provisions enacted in the NCA.[41] It is however likely that the legislature perceived that by allowing the mechanism of common-law set-off to apply unabated it would (potentially) operate to the detriment of consumers who might find themselves out of pocket and unable to have funds for their livelihood if set-off can for instance occur against a current account in which their salary is deposited in order to pay an arrear instalment in terms of an instalment agreement where both these accounts are with the same bank. Consumers might even want to avoid such a situation altogether by having their current or savings account at a bank other than a bank at which they have their mortgage agreements, loans and other credit agreements – however there may be many consumers who do not have this option for a variety of reasons such as that it is the only bank where they could get credit or if their employer obliges them to keep their accounts only with a certain bank.

3 *The banking industry's lack of compliance with section 124*

On a practical level it appears that, the banking industry, by and large, is not using the provisions of section 124 and that currently the provisions of the section are a dead letter in the law book. The reason for the position taken by the banking industry is apparently based on a legal opinion that was obtained and as a result whereof Standard Bank publicly stated: "Our interpretation is that the common law rule of set-off can be applied because section 124 does not amend or replace this rule."[42] Van Deventer indicates that the banks rely on the fact that section 90(2)(n) refers to a "provision" in a credit agreement that will be unlawful if it allows set-off contrary to section 124. Hence the argument goes that as long as the banks do not specifically incorporate a provision in a credit agreement relating to set-off they can continue to apply the common-law right of set-off. Van Deventer aptly remarks:

> "If the above interpretation is correct, the provisions of the NCA will apply even if the clause contained in a credit agreement does not add to the bank's common law right to set-off in any way but merely confirms it. This gives rise to the rather strange, if not downright bizarre, situation that in order to retain its right (to apply set-off) a credit provider must refrain from stipulating such a right in a credit agreement."[43]

[41] Van Deventer (n 7 (2016)) 126-135 indicates that the policy documents informing the NCA do not provide any clear indication as to the legislature's intention regarding set-off. She also competently (in accordance with s2(2) of the NCA that allows for the consideration of appropriate foreign law in the interpretation of the Act) probes foreign credit legislation to ascertain whether any such legislation may have informed the enactment of s124 but concludes that s 124 appears not to have been informed by any foreign legislation providing for set-off.

[42] as stated on 18 January 2017 by Standard Bank spokesperson Ross Linstorm in an interview with Matthew Le Cordeur of Fin24 (http://www.fin24.com (accessed 29 September 2017)).

[43] Van Deventer (n 7 (2016)) 117-118.

It is submitted that the interpretation on which the banks rely constitutes a formalistic approach which negates the real issue namely that the legislature wanted to do away with the common- law right to set-off in the context of credit agreements and accordingly prescribed a procedure for statutory set-off in section 124. The existence of section 90(2)(n) however inappropriately worded does not detract from the fact that the legislature enacted the procedure for statutory set-off in section 124 read with regulation 38 and Form 27. Section 124 determines how this statutory set-off may be effected. Section 90(2)(n) merely states that if a credit agreement contains a provision that allows for set-off contrary to section 124 such provision will be invalid – in essence it thus reinforces that set-off has to occur as stated in section 124.

The Code of Banking Practice, being a voluntary code ascribed to by all banks in South Africa that are members of the Banking Association of South Africa (BASA) and which explains to consumers what their rights and obligations in various respects are when transacting with banks, however also does not underwrite strict compliance with section 124 of the NCA. The Code addresses the issue of set-off in paragraph 7.5 which provides as follows:

> "When you open an account, we will provide you with information that will include clear and prominent notice of any rights of set-off that we may claim over credit and debit balances in your different accounts.
>
> When you obtain credit from us, we may require your consent to set-off any outstanding amounts against funds available in other accounts you hold with us. Any such arrangement will be concluded *in terms of the requirements of the NCA*, if the credit agreement is subject to the NCA.
>
> We will inform you promptly *after* we have effected set-off in respect of any of your accounts. You will receive timely statements (if statements are generally produced on the relevant account), which will reflect the set-off position.
>
> Prior to setting off your debit and credit balances, we may elect to place any of your funds *on hold* pending a discussion with you on any amount owed to us." [44]

There may indeed be situations where the NCA is not applicable and in which the above paragraph of the Code of Banking Practice cannot be faulted. However insofar as credit agreements governed by the NCA are concerned, this paragraph is problematic. This is because despite the statement in paragraph 7.5 that banks will give their customers an indication in the bank-customer agreement regarding how set-off will be applied to debit and credit balances in the consumer's account (*eg* current or savings account) it is submitted that section 124 constitutes a *lex specialis* that will govern the application of set-off in the context of credit in instances where the NCA applies. From paragraph 7.5 it appears as if banks will apply set-off in the context of credit in compliance with the requirements of the NCA, hence the statement that any set-off arrangement "will be concluded in terms of the requirements of the NCA". However, on closer inspection it seems that banks are not committing themselves to strict compliance with the NCA. Notably it is indicated that the bank will only notify

[44] Author's emphasis.

the consumer of the set-off *after* such set-off has been effected which is in stark contrast with section 124 that requires elaborate notification *prior* to effecting set-off. Banks also entitle themselves to "freeze" or place the customer's funds "on hold" prior to effecting set-off.

4 *Steps taken by the National Credit Regulator*

The National Credit Regulator (NCR) has approached the North Gauteng High Court in January 2017 to apply for a declaratory order against Standard Bank on the basis that the common law set-off has been superseded by section 124 of the NCA.[45] This matter has yet to be heard by the court. One of the reasons that the NCR advances for seeking such relief is that unfettered application of set-off as allowed for by the common law can cause financial hardship to a consumer especially where its effect is that the consumer is left "with little or no money to pay other creditors or meet their living obligations."[46]

5 *Viewing set-off through the prism of the Constitution*

When interpreting the NCA, section 2(1), which states that the Act must be interpreted in a manner that gives effect to the purposes of the NCA as set out in section 3 thereof, must be observed. These purposes are to "promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry and to protect consumers". These objects are sought to be achieved inter alia by promoting the development of a credit market that is accessible to all South Africans particularly those who have historically been unable to access credit under sustainable market conditions[47] and promoting equity in the credit market by balancing the rights and responsibilities of credit providers and consumers respectively.[48] Notably one of the purposes of the NCA is also to avoid over-indebtedness of consumers[49] – an outcome that can be achieved by using the mechanism of set-off.

As pointed out at the beginning of this contribution, the NCA is post-constitutional legislation and was drafted in an era of constitutional supremacy when the values enshrined in the Constitution had already been permeating legislation for nearly ten years. This aspect also informs the context in which the NCA should be interpreted.[50] It can be accepted that the legislature, being fully aware of the unfair treatment of consumers in the previous credit dispensation, regarded the common law of set-off as enabling credit providers to inflict

[45] Media Release by NCR dated January 2017 entitled "The National Credit Regulator applies for a declaratory order in the North Gauteng High Court" (also reported at http://www.fin24.com (accessed 29 September 2017)).
[46] *Ibid*.
[47] s 3(a).
[48] s 3(d).
[49] s 3(c).
[50] S 39(2) of the Constitution provides that, when interpreting legislation, the spirit and object of the Bill of Rights must be advanced.

hardship upon consumers especially given its *ipso iure* application that would not allow the consumer any *ex ante* recourse against the appropriation of money in an account kept with the credit provider.[51] Constitutional rights of the consumer that may be infringed by the *ipso iure* application of the common law of set-off would arguably be the right to dignity (section 10)[52] and the right to property (section 25)[53] and possibly even the right to access to courts (section 34).[54]

It is submitted that there can be little doubt that the legislature intended the common-law right to set-off to be superseded by the provisions of section 124 and that reliance on an artificial construction of section 90(2)(n) will not change this reality. The question should thus now not be about whether banks are still allowed to apply their common-law right of set-off in the context of credit agreements to which the NCA applies but rather whether section 124 in any way offends the Constitution – and whether this provision could be struck down as unconstitutional and so reintroduce the common-law right to set-off through the back door – at least pending an amendment of the Act especially given that the legislature missed the opportunity to address the uncertainties surrounding section 124 via the National Credit Amendment Act.[55] This argument will have to come from the banks – clearly consumers who are enjoying the protection of section 124 will not argue that the section is unconstitutional. Thus the banks will have to allege which constitutional right of theirs is being infringed – and they would probably argue that section 124 infringes on their right to property as it takes away the opportunity to *ipso iure* obtain payment of a debt that they previously had and in effect it enables the consumer to move the money in the relevant account completely out of their (previously legitimate) reach. In the unlikely event that a court agrees with them on this point this is however not where the enquiry will end because it will not be enough to merely indicate that they were deprived of property but they will also have to prove that such deprivation is arbitrary. The mere fact that a provision is onerous and occasions greater and more costly compliance by credit providers does not make it unconstitutional. Neither does the fact that it limits a right that credit providers previously enjoyed in a rather unbridled fashion. The litmus test for determining whether section 124 is unconstitutional will be whether it offends a right in the Constitution in such a manner that it cannot be justified in terms of the limitation clause in the Constitution.

[51] See Van Deventer (n 7 (2016)) 123 where she indicates that one of the disadvantages of the application of common-law set-off is that the person against whom set-off is *ipso iure* effected without notification does not have the opportunity to raise any defences.

[52] S 10 of the Constitution provides that "[e]veryone has inherent dignity and the right to have their dignity respected and protected."

[53] S 25(1) provides that "[n]o one may be deprived of property except in terms of law of general application and no law may permit arbitrary deprivation of property."

[54] S 34 provides that "[e]veryone has the right to have any dispute that can be resolved by the application of law decided in a fair public hearing before a court or, where appropriate, another independent and impartial tribunal or forum."

[55] As pointed out by Van Deventer (n 7 (2016)) 118. She also points out that the Ombudsman for Banking Services was of the view that the dispute between the National Credit Regulator should be settled by a legislative amendment or a court judgment.

Section 36 allows for the limitation of rights in the following terms:

"(1) The rights in the Bill of Rights may be limited only in terms of law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including-
   (a) the nature of the right;
   (b) the importance of the limitation;
   (c) the nature and extent of the limitation;
   (d) the relation between the limitation and its purpose; and
   (e) less restrictive means to achieve the purpose.

(2) Except as provided in subsection (1) or any other provision of the Constitution, no law may limit any right entrenched in the Bill of Rights."

Having regard to the constitutional rights of consumers that can probably be said to be infringed by the continued application of the common law of set-off it appears that the legislature had a sound rationale for enacting section 124 and that it will not be held to constitute an arbitrary deprivation of property.

It appears that the yardstick for determining the constitutionality of section 124 will largely be whether the procedure prescribed in the section is disproportional to the achievement of its objective and whether there is a less restrictive means to achieve the same purpose.

Here one can possibly consider again the advantages and disadvantages of common-law set-off and statutory set-off respectively to determine whether the onerous procedure for statutory set-off could be toned down. As indicated this procedure will bring about increased compliance costs that will eventually be filtered through to consumers, making credit more expensive. The requirement of prior notification may also create the opportunity for consumers to move money from accounts and so to frustrate the credit provider's attempt at set-off. The advantages of applying a mechanism such as set-off in commercial transactions is clear and the opportunity for credit providers to employ this mechanism to "grab" money in a consumer's account that was intended to fund his livelihood has been significantly curtailed by the requirement of prior notification of set-off as per section 124(2) – probably the legislature went too far in this regard. It is arguable that section 124 needs to be balanced as the onerous procedure it has created appears largely to work in favour of consumers without consideration of the need, as acknowledged in the purposes of the NCA, to actually balance the rights of consumers and credit providers in the interests of a sustainable and accessible credit market. One can agree with Van Deventer when she states: "It can therefore not be said that allowing set-off by credit providers goes against the spirit and intent of the [NCA] in all respects"; and also with the sentiment she expresses that although the right to set-off can be abused (and it is submitted that this is especially pertinent in the context of common-law set-off), abolishing it completely would also have adverse effects.

It will require some creative thinking to come up with an appropriate solution. Van Deventer suggests that a balance between the rights of credit providers can possibly be struck by removing the requirement of prior notification in section

124.[56] This appears to be a sensible suggestion as such a move will also eliminate the uncertainty surrounding the time at which notice has to be given as alluded to above. Another useful suggestion that was made informally by my colleague Reghard Brits, is that an *ex post* procedure could possibly be considered in terms whereof the credit provider has to notify the consumer only after set-off is effected and allowing the consumer who is aggrieved by such set-off because it, for instance, caused him the type of financial hardship that the National Credit Regulator had in mind, to present reasons why the set-off should be reversed.

[56] Van Deventer (n 7 (2016)) 140.

CoFI and T(CF): Further along the road to Twin Peaks

DALEEN MILLARD*

1 *Introduction*

The road to hell is no doubt paved with good intentions. This aphorism essentially teaches that promises and plans must be put into action, otherwise they are useless. In insurance law, which forms the basis of the present discussion, the legislature has been active in paving the way for the implementation of the Twin Peaks system of regulation. The purpose of the discussion is primarily to sketch the progress that has been made to effect changes to the current statutory framework as it applies to insurance and secondly to evaluate the impact of the reforms that pertain to market conduct. The contribution will proceed by briefly sketching the rationale behind the move to Twin Peaks, which includes a cursory overview of the Financial Sector Regulation Act.[1] This will be followed by an exposition of the statutory amendments that form the milestones along the way to Twin Peaks. The focus of the contribution is on the reforms that are expected to have the highest impact on market conduct in the industry. The discussion will inevitably canvass the role of the Insurance Act (currently, the Insurance Bill) and the proposed amendments to the Policyholder Protection Rules (PPRs) in terms of the Long-term Insurance Act (LTIA)[2] and the Short-term Insurance Act (STIA).[3] The expected role of the Conduct of Financial Institutions Bill (CoFI) will also be evaluated, especially since market conduct plays a pivotal role in protecting consumers' rights.

2 *Why Twin Peaks?*

The much-anticipated Financial Sector Regulation Act was signed into law on 21 August 2017.[4] According to section 305 of this Act, different sections will commence on different dates and provisions that repeal or amend other statutes will also commence on dates as determined by the Minister of Finance.[5]

* BIur LLB LLM (UP) LLD (UJ). Professor of Private law, University of Johannesburg.

1 9 of 2017.

2 52 of 1998.

3 53 of 1998.

4 This statute was preceded by the Financial Sector Regulation Bill that was published in December 2014. The Bill was the first step towards the implementation of the Twin Peaks model. The two policy papers that informed the Bill were: National Treasury *A Safer Financial Sector to Serve South Africa Better* (February 2011) (www.nationaltreasury.org (visited 23 September 2017)) and Financial Regulatory Reform Steering Committee *Implementing a Twin Peak Model of Financial Regulation in South Africa* (February 2013) (www.nationaltreasury.org (visited 23 September 2017)).

5 www.nationaltreasury.org (visited 23 September 2017).

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Also known as the Twin Peaks Act, this statute creates a prudential regulator, the Prudential Authority, while the Financial Services Board (FSB) will be transformed into a dedicated market conduct regulator known as the Financial Sector Conduct Authority. The Prudential Authority will be housed in the South African Reserve Bank (SARB).

The main aim of the implementation of the Twin Peaks model in South Africa is to create a more resilient and stable financial system and to strengthen the country's approach to consumer protection and market conduct in the financial services industry.[6] Treasury describes this aim as follows:

> "A stable and more inclusive financial sector is needed to support increased economic growth in South Africa. At a macroeconomic level, a stable and well-developed financial sector supports real economic activity through the efficient channelling of savings into productive forms of investment, contributing to the country's objectives on job creation and a more inclusive economy (as set out in the National Development Plan). For individuals and firms, access to affordable and reliable financial products and services enables people to engage in economic transactions on a daily basis, to save for retirement and other long-term goals, to insure against varied risks, and to avoid an over-reliance on debt and exploitative or reckless lending practices. Access to appropriate financial products and services in South Africa is necessary if economic growth and well-being is to be genuinely inclusive."[7]

In order to achieve these goals the Prudential Authority's main task will be to promote and enhance the safety and soundness of regulated financial institutions while the Financial Sector Conduct Authority will protect consumers of financial services by supervising market conduct. Prudential standards are notably the Financial Soundness Standards that were released for comment on 4 November 2016, Governance Standards that replaced Board Notice 158 of 2014 and the Outsourcing Directive, Auditing Standards (comprising auditing requirements and the duties and functions of auditors) and Reporting Standards.[8]

Even though there is a lot of hype around the market conduct aspect of Twin Peaks, it would be incorrect to state that there has never been legislation to promote the safety and soundness of insurers as financial institutions. It will be even more erroneous to argue that market conduct regulation is new, which is why the point of departure of any valuable discussion should be the existing rules on market conduct. As legislative reforms are published and promulgated, it makes sense to contextualise these by considering whether it bears resemblance to well-established rules that served the market well.

With this in mind, the next section will first provide an overview of existing legislation and will then map the statutory reforms to insurance legislation.

[6] www.fsb.co.za (visited 12 September 2017).

[7] National Treasury *Media Statement: Publication Update for Twin Peaks Financial Sector Regulatory Reform Programme* (21 July 2016) (www.nationaltreasury.org (visited 5 October 2017)).

[8] See in general Financial Services Board *Insurance Regulatory Framework Update* (November 2016) (www.fsb.co.za (visited 24 September 2017)).

3 *Overview of statutory amendments to insurance legislation*

3.1 Current statutory framework

It is trite that insurance in South Africa is strictly regulated.[9] Although legislation plays an important role in insurance, common-law principles (especially pertaining to insurance contracts) and precedents are sources of insurance law that provide important rules pertaining to doctrines such as subrogation,[10] average,[11] over-insurance[12] and fraud.[13] Precedents constitute a very important source of insurance law as is evident from landmark rulings such as *Mutual and Federal Insurance Co v Oudtshoorn Municipality*.[14]

Legislation includes the LTIA, STIA and the Financial Advisory and Intermediary Services Act (FAIS Act).[15] The LTIA and STIA aim to regulate the registration of insurers and to control certain activities of insurers and as such contain rules on prudential matters as well as rules on market conduct. An excellent example of market conduct regulation is found in the two sets of PPRs in terms of the LTIA and the STIA.

The true revolution in market conduct regulation was brought about by the FAIS Act. This statute contains strict rules on the conduct of financial advisors and intermediaries.[16] As this statute applies to all insurance products, the insurance industry was faced with a host of very detailed rules on matters such as what constitutes advice[17] and intermediary services,[18] the appropriateness of advice and how to avoid conflict of interest between a broker and a client.

Before the promulgation of the FAIS Act advice and intermediary services regarding financial products were regulated by the law of agency and mandate[19] and Roman-Dutch principles dictated the standards to which the conduct of

[9] Millard *Modern Insurance Law in South Africa* (2013) 7.

[10] Reinecke, Van Niekerk and Nienaber *South African Insurance Law* (2013) 385-389.

[11] Reinecke, Van Niekerk and Nienaber (n 10) 502-503. See *O'Flynn v Equitable Fire Insurance and Trust Co; Joseph O'Flynn v Commercial Assurance Co* (1866) 1 Roscoe 372; *Kaffrarian Colonial Bank v Grahamstown Fire Insurance Co* (1885) 5 EDC 61; *Mutual and Federal Insurance Co v Chemalum (Pty) Ltd* 2007 (2) SA 479 (SCA).

[12] Reinecke, Van Niekerk and Nienaber (n 10) 489-490. See *Nafte v Atlas Insurance Co Ltd* 1924 WLD 239.

[13] Reinecke, Van Niekerk and Nienaber (n 10) 373-383. Fraud in insurance takes many forms, ranging from inflated claims to intentional misrepresentations regarding the realizing of the risk. Principles pertaining to fraud are based on common law and a variety of contractual clauses usually determine the rights and duties of the parties where fraud occurs. For a detailed discussion, see Millard "*P K Harikasun v New National Assurance Company Ltd (Unreported case High Court, KwaZulu Natal case nr 190/2008 of 12 December 2013)* Of red herrings, sardines and insurance fraud: Something's fishy!" 2016 2 *De Jure* 155-167.

[14] 1985 1 SA 419 (A).

[15] 37 of 2002.

[16] Van Zyl *Financial Advisory and Intermediary Services Manual* (2004) 1-11.

[17] s 1 of the FAIS Act, *sv* "advice". Advice is any recommendation, guidance or proposal of a financial nature furnished by any means or medium to any client or group of clients.

[18] s 1 of the FAIS Act, *sv* "intermediary service". This includes any act other than the furnishing of advice that is performed by a person for or on behalf of a client or product supplier that results in the client entering into or offering to enter into any transaction in respect of a financial product with a product supplier.

[19] Havenga *The Law of Insurance Intermediaries* (2001) 1.

financial advisers and intermediaries were held.[20] Therefore, even though the FAIS Act did not replace the rules pertaining to agency and mandate, detailed provisions in the Codes of Conduct in terms of the FAIS Act (notably the general Code of Conduct (GCC)) introduced certain minimum standards and in a sense replaced the values-based law of agency and mandate with a more detailed rules-based approach.[21]

Opinions vary on the success of the FAIS Act but if the number of FAIS Ombud cases are anything to go by it is perhaps worthy to consider that the volume of daily transactions compared to the volume of complaints indicates that financial advice and intermediary services in the insurance industry seem to be quite successful.

It is therefore the hypothesis of this article that even though Twin Peaks is here to stay, all legislative reforms on the way to Twin Peaks should enhance and strengthen the existing legal framework and should guard against adopting more legislation for the sake of it. With that in mind, the next paragraph will sketch the milestones in legislative reforms on the way to Twin Peaks.

3.2 Legislative milestones

The ideal of Twin Peaks regulation necessitated a critical overview of all financial legislation, including insurance legislation, in order to anticipate and address a variety of issues, including overlaps, conceptual issues and the expected role of the various regulators. What was of paramount importance in the whole process was to ensure that loopholes were covered and that the distinction between prudential oversight and market conduct was clear. In practice, that means that the so-called "Tranche 1" amendments to the Regulations in terms of the LTIA and STIA and PPRs were prioritised. The promulgation of the Insurance Bill Act will necessitate further consequential amendments to the LTIA and STIA, followed by the "Tranche 2" amendments to the regulations in terms of the STIA and LTIA.[22] It is further expected that these two statutes will only be repealed after the promulgation of the CoFI Act. With this in mind, the Insurance Bill will now be discussed.

3.3 Insurance Bill

The Bill, as tabled, clearly sets out its objectives in the preamble:

> "To provide for a legal framework for the prudential supervision of insurance business in the Republic that is consistent, where relevant, with international standards for insurance regulation and supervision; to introduce a legal framework for microinsurance to promote financial inclusion; to replace certain parts of the Long-term Insurance Act, 1998, and the Short-term Insurance Act, 1998; and to provide for matters connected therewith."

The Insurance Bill has a strong prudential focus and this aspect is probably the most marked difference between the Insurance Bill and the LTIA and STIA. The

[20] Havenga (n 19) 3-4.
[21] Millard and Hattingh *The FAIS Act Explained* (2016) 85-86.
[22] FSB (n 8).

latter two statutes have traditionally distinguished between non-indenmity and indemnity insurance and both statutes contain aspects of prudential regulation and market conduct. Most notably, on the prudential side, these two statutes regulated the administration of insurance through the respective registrars for long-term insurance and short-term insurance,[23] the registration of insurers,[24] post-registration responsibilities and constraints of registered insurers,[25] assets and financial obligations,[26] compromises, arrangements, amalgamations, demutualisations and transfers[27] and judicial management and the winding-up of long-term insurers.[28] What is now known as market conduct is found in the second portion of these statutes and can be summarised as business practice, policies and policyholder protection.[29] In a sense, offences and penalties regulate both prudential and market conduct matters. It is therefore evident that the LTIA and the STIA contain aspects of prudential regulation and market conduct.

Perusal of the Insurance Bill reveals that it consolidates the prudential regulatory framework for long-term (non-indemnity or life) insurance and short-term (indemnity or non-life) insurance. The Bill is structured in such a way that the technical requirements (such as prudential standards) will be contained in the regulations. This Bill, once enacted, will repeal the prudential sections of the LTIA and the STIA.

The focus on the proportionality principle deserves some further attention. All standards pertaining to financial soundness, governance and reporting differentiate between insurers, insurance groups, microinsurers, Lloyd's and branches of foreign insurers.[30] It is submitted that this distinction is long overdue as standards should be appropriate to the structure and nature of the business. It has become particularly evident that there is a need for microinsurers to market and sell products that are aimed at a niche market. To subject microinsurers to the same standards as groups of companies is inappropriate, cumbersome and stifling. It is further encouraging that the Bill contains a definition of microinsurance as a point of departure. The definition reads as follows:

> "microinsurance business" means insurance business—
>
> (a) conducted in respect of any of the following classes and sub-classes of insurance business set out in Schedule 2—
>
> (i) life insurance business, classes 1, 3, 4 or 9; and
>
> (ii) non-life insurance business, in the sub-class personal lines in—
>
> (aa) classes 1, 2, 9, 11, 14 or 17; and (bb) class 10, but only to the extent that the insurance obligations directly relate to the classes referred to in item (aa); and
>
> (b) in the case of life insurance business and class 14 referred to in paragraph (a)(ii)(aa), in respect of which the aggregate value of the insurance obligations relating to each life insured under an insurance policy does not exceed the maximum amounts prescribed; and

[23] s 2 of the LTIA and s 2 of the STIA.
[24] s 7 of the LTIA and s 7 of the STIA.
[25] ss 15-28 of the LTIA and ss 15-27 of the STIA.
[26] ss 29-36 of the LTIA and ss 28-35 of the STIA.
[27] ss 37-40 of the LTIA and ss 36-39 of the STIA.
[28] ss 41-43 of the LTIA and ss 40-42 of the STIA.
[29] ss 44-65 of the LTIA and ss 43-55 of the STIA.
[30] See par 3.4 below.

(c) in the case of non-life insurance business other than class 14 referred to in paragraph (a)(ii)(aa), in respect of which the aggregate value of the insurance obligations under an insurance policy does not exceed the maximum amounts prescribed; and

(d) in respect of which the aggregate value of the insurance obligations under all insurance policies issued by the same insurer to the same policyholder does not exceed the maximum amounts prescribed under paragraphs (b) and (c).

It is expected that a proper prudential framework for microinsurance will strengthen this aspect of insurance law and that it has the potential to provide access to affordable insurance products to indigent consumers.

Overall, the Insurance Bill complements the broader financial sector reforms and is an important building block in the new financial landscape.

3.4 Amendments of regulations to the LTIA and STIA

The main aim of amendments to the regulations in terms of the LTIA and the STIA is to provide for the all-important incorporation of the new PPRs and to issue rules on the conduct of business. The PPRs have always provided important rules on consumer protection but were at the same time quite limited. The proposed PPRs are discussed in 3.5 below. Other matters that resort under conduct of business include various Board Notices, Insurance Notices and conduct standards that may be necessary to enforce the ideals of Twin Peaks.

3.5 Proposed PPRs

3.5.1 Background

As a matter of background: The PPRs are promulgated in terms of section 62 of the LTIA and section 55 of the STIA. Presently, these two sets of PPRs are very similar and other than the definition section,[31] objectives[32] and application[33] of the rules, these stipulate rules for direct marketers,[34] agreements with intermediaries,[35] rules on cancellation of policies and cooling off,[36] rules on fund policies,[37] assistance business group schemes,[38] additional insurer duties[39] and miscellaneous provisions.[40]

While the PPRs have always constituted important consumer protection measures, many aspects of market conduct regulation resorted under the FAIS Act. This had the effect of placing a disproportionate responsibility on intermediaries and advisors while failing to address product issues such as exclusions, fair claims procedure and other onerous clauses in insurance

[31] rule 1 of both sets of PPRs
[32] rule 2 of the Long-term PPRs.
[33] rule 3 of the Long-term PPRs.
[34] rule 4 of the Long-term PPRs.
[35] rule 5 of the Long-term PPRs.
[36] rule 6 of the Long-term PPRs.
[37] rule 7 of the Long-term PPRs.
[38] rules 8-15 of the Long-term PPRs.
[39] rules 16-18 of the Long-term PPRs.
[40] rules 19-22 of the Long-term PPRs.

contracts itself. There are examples of where product issues were laid at the door of the advisor or intermediary.[41]

To complicate matters, the FAIS Ombud openly states that insurers have to comply with the "Treating Customers Fairly" or "TCF Principles" and one such pronouncement to this effect is found in the recent Ombud determination in *Forge v Old Mutual.*[42] In this determination, the Ombud pronounces with great conviction that "Financial Services Providers (FSPs) respondents are bound by the 'Treating Customers Fairly' (TCF) principles, which have now been accepted within the entire financial services industry."[43] In the absence of the formal promulgation of legislation that incorporates TCF there has been uncertainty on the legal status of these rules. In fact, when first published on the Financial Services Board's website, insurers and individuals were faced with what was essentially two distinct streams of regulation, namely the insurance statutes and FAIS Act on the one hand and TCF on the other.[44]

The publication of the First Draft PPRs in terms of the LTIA and the STIA brought some certainty as to the legislature's formal views on the role of TCF.[45] It is patently clear that the strategy is to formally incorporate TCF into the PPRs.[46] More specifically, chapter 2 rules 1 and 2 of the first draft of the proposed PPRs emphasise that insurers must act with skill, care and diligence and should act professionally, honourably and with due regard to the convenience of the client.[47] Furthermore, rule 1.3 formally incorporates TCF into the legal framework. The rule states that an insurer "must have appropriate policies and procedures in place to achieve the fair treatment of policyholders" and further stipulates that policies and procedures must achieve the following six outcomes, namely:

"(a) policyholders are confident that they are dealing with an insurer where the fair treatment of policyholders is central to the insurer's culture;

(b) products are designed to meet the needs of identified customer groups and are targeted accordingly;

(c) policyholders are given clear information and are kept appropriately iformed before, during and after the time of entering into a policy;

(d) where policyholders receive advice, the advice is suitable and takes account of their circumstances;

(e) policyholders are provided with products that perform as insurers have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect; [and]

(f) policyholders do not face unreasonable post-sale barriers to change or replace a policy, submit a claim or make a complaint.

41 See *eg Masimdumise Gabriel Bhengu v Outsurance Insurance Co Ltd* case number FAIS 06001/14–15/KZN 3.

42 case number FAIS 03558/16-17 KZN 4. For a discussion of the determination, see Millard (2017) 20 *Juta's Insurance L Bul* 43-47.

43 par 39.

44 Millard "Through the looking glass – fairness in insurance contracts: A caucus race?" 2014 *Journal of Contemporary Roman-Dutch Law* 547-566.

45 Financial Services Board "Proposed replacement of the Policyholder Protection Rules made under the Long-term Insurance Act, 1998 and the Short-term Insurance Act, 1998 – document supporting consultation" (December 2016) (www.fsb.co.za (visited 20 January 2017)).

46 Millard (2017) 20 *Juta's Insurance L Bul* 1.

47 Proposed rule 1.2 6*(a)* and 1.2 6*(b)* of the proposed rules.

These Draft PPRs were published for public comment and as can be expected, various stakeholders provided the FSB with comments and suggestions. Comments were combined in a Comments Matrix and published during September 2017.[48] The Matrix spans some 337 pages and the content of each comment cannot be canvassed in this discussion. It is sufficient to state that general comments and criticisms against the Draft PPRs include *inter alia* the fact that the constitutionality of these rules had not been considered.[49] Another general comment addressed the proposed penalties for contravention of any of the rules contained in the Draft PPRs.[50] Although the FSB did not comment on the constitutionality of the rules, the suggested penalties for contravention of the rules were removed.[51]

The Comments Matrix contains several other useful suggestions. One that deserves to be mentioned is employee benefits in terms of group schemes.[52] Comments include *inter alia* that the Regulator should distinguish between voluntary and compulsory group schemes and that the conceptual framework may benefit from a revised definition of "policyholder".[53] This in fact prompted the Regulator to re-consider the draft definition of "policyholder". Furthermore, comments questioned the way in which the Draft PPRs will apply to group schemes. This is an excellent example of how public comments can influence the drafting of legislation. For group schemes, the difficulty has always been that policies are negotiated by employers or trade unions on behalf of groups of employees. This means that advice and intermediary services are inevitably provided to employers or trade unions and not to employees.[54] Although there are many benefits to be had by employees who participate in group schemes or fund policies, it can also result in employees' or trade union members' exclusion from certain benefits and their resultant unfair treatment.

This aspect was apparently considered in producing the second draft of the PPRs. The second draft appears less cluttered and already shows an improvement on the first. It is in all likelihood too soon to comment provide comments on the finer details of these provisions. What is perhaps more useful is a back-to-back comparison, in tabular form, of the first and second drafts of the PPRs for the short-term and long-term industries:

[48] Draft Replacement of the Policyholder Protection Rules, 2017 – Comments Matrix (September 2017) (www.fsb.co.za (17 September 2017)).
[49] Comments Matrix (n 48) 330.
[50] Comments Matrix (n 48) 326.
[51] *Ibid.*
[52] Comments Matrix (n 48) 322-324.
[53] *Ibid.*
[54] Nienaber and Reinecke *Life Insurance In South Africa* (2009) 79. The writers mention that "group scheme" is defined in the regulations to the LTIA as "a scheme or arrangement which provides for the entering into of one or more policies, other than an individual policy, in terms of which two or more persons without an insurable interest in each other, for the purposes of the scheme, are the lives insured."

SHORT-TERM INSURANCE			
FIRST DRAFT		SECOND DRAFT	
RULE	STIPULATION	RULE	STIPULATION
1.	Policies and procedures dealing with the fair treatment of policyholders	1	Requirements for the fair treatment of policyholders
2.	Product line design	2.	Product design
3.	Consumer credit insurance	3.	Consumer credit and credit life insurance
4.	Cooling-off rights	4.	Cooling-off rights
5.	Negative option selection of policy terms or conditions	5.	Negative option selection of policy terms or conditions
6.	Determining premiums	6.	Determining premiums and excesses
7.	Void provisions	7.	Void provisions
8.	Waiver of rights	8.	Waiver of rights
9.	Signing of blank or uncompleted forms	9.	Signing of blank or uncompleted forms
10.	Consent required to insure a life	10.	Advertising
11.	Advertising, brochures and similar communications	11.	Disclosure
12.	Disclosure and record keeping	12.	Arrangements with intermediaries or other persons
13.	Arrangements with intermediaries	13.	Data management
14.	Data management	14.	On-going review of product performance
15.	On-going review of product line performance	15.	Periods of grace
16.	Periods of grace	16.	Record keeping
17.	Claims management	17.	Claims management
18.	Complaints management	18.	Complaints management
19.	Termination of policies	19.	Termination of policies

LONG-TERM INSURANCE			
FIRST DRAFT		SECOND DRAFT	
RULE	STIPULATION	RULE	STIPULATION
1.	Policies and procedures dealing with the fair treatment of policyholders	1.	Requirements fort eh fair treatment of policyholders
2.	Product line design	2.	Product design
3.	Consumer credit insurance	3.	Credit life insurance
4.	Fund policies	4.	Cooling- off rights
5.	Cooling-off rights	5.	Negative option selection of policy terms or conditions
6.	Negative option selection of policy terms or conditions	6.	Determining premiums
7.	Determining premiums	7.	Void provisions
8.	Void provisions	8.	Waiver of rights
9.	Waiver of rights	9.	Signing of blank or uncompleted forms
10.	Signing of blank or uncompleted forms	10.	Advertising
11.	Consent required to insure a life	11.	Disclosure
12.	Policy loans and cessions	12.	Arrangements with intermediaries or other persons
13.	Advertising, brochures and similar communications	13.	Data management
14.	Disclosure and record keeping	14.	On-going review of product performance
15.	Arrangements with intermediaries	15.	Premium reviews
16.	Data management	16.	Record keeping
17.	On-going review of product line performance	17.	Claims management
18.	Premium reviews	18.	Complaints management
19.	Claims management	19.	Replacement of policies
20.	Complaints management	20.	Termination of policies
21.	Replacement of policies		
22.	Termination of policies		

While it is too soon to become entangled in detais, it is imperative to grasp the significance of the the explicit inclusion of the well-known principles of TCF. It clearly supports a drive to include fairness as an underlying principle of the market-conduct aspect of insurance.

It is however not only the inclusion of the six outcomes of TCF that explicitly incorporates fairness. The best examples of the inclusion of fairness as a basis is found in the provisions on on advertising, data management, on-going review of product line performance, conflict of interest, time-bar clauses, complaints management and cooling-off rights for all kinds of policies.[55] Other examples of the incorporation of fairness include statutory periods of grace for short-term policies, a fairer dispensation for holders of fund policies, policy loans and sessions and premium reviews for long-term insurance.[56] These provisions will be discussed in more detail, considering both the first and second drafts of the PPRs.

3.5.2 Advertising

Advertising of insurance products forms part of the second phase of the product life-cycle. Advertisements of insurance products have been regulated for quite some time. In fact, regulation 3 of the FAIS Act provides that only authorised financial services providers may market or sell insurance products. The GCC in terms of the FAIS Act stipulates in no uncertain terms that financial services providers may not place advertisements that are fraudulent, untrue or misleading.[57] Currently, advertisers must also ensure that where an advertisement includes performance data, the source and date of the source must be provided.[58] In addition, if an advertisement uses illustrations, forecasts or hypothetical data it must include the assumptions upon which these are based, clarified that it is used only for illustrative purposes and indicate whether the returns are dependent on underlying assets or variable market factors.[59] These rules are no doubt aimed at ensuring that members of the public are not mislead.

The First Draft PPRs addressed fairness in advertising from a public interest perspective. The proposed rule 11.4(a) of the short-term PPRs and rule 13.4(a) of the long-term PPRs stipulate that advertisements, brochures or similar communications must not disparage financial products, product suppliers or intermediaries. In addition, the first draft rules stipulate that advertisements for insurance must not make inaccurate, unfair or unsubstantiated criticisms of any other financial product, product supplier or intermediary.

It seems that "unfair criticism" is a very wide concept and it is evident that the First Draft of the PPRs invited widespread criticism from stakeholders.[60] Apparent confusion on matters such as the scope of information that should be

[55] Millard (n 9) 6-15.
[56] Millard (n 9) 15-18.
[57] par 14 of BN 80 in GG 25299 of 8 August 2003. See also Millard and Hattingh (n 21) 114.
[58] par 14(1)*(a)* of BN 80 of 2003.
[59] par 14(1)*(b)*(ii) of BN 80 of 2003.
[60] See Comments Matrix (n 48) 22, 29, 31, 33, 34, 63, 75, 77, 78, 79, 80, 81.

disclosed in an advertisement, what constitutes an advertisement, what exactly will constitute "inducement", whether all members of the public who react to an advertisement may be regarded as potential policyholders and the difference between advertisements and actual advice.

Instead of simplifying the Second Draft of PPRs, the Regulator opted to provide even more detail. The proposed rule 10 for both sets of PPRs now includes definitions of "advertising",[61] "comparative", "endorsement", "holding company", "publish",[62] "puffery" and "social media".

In addition to having added definitions, further detailed rules have been incorporated to illustrate concepts used in relation to advertising. This unfortunate turn of events is evident from the proposed rule 10.4 which provides as follows:

> "10.4. Factually correct, balanced and not misleading
>
> 10.4.1 Advertisements must –
> (a) be factually correct;
> (b) provide a balanced presentation of key information; and
> (c) must not be misleading.
>
> *Factually correct*
>
> 10.4.2 If statistics, performance data, achievements or awards are referenced in an advertisement the source and the date thereof must be disclosed.
>
> 10.4.3 An advertisement that refers to premiums must –
> (a) in the case where the premium will escalate automatically, indicate the escalation rate or basis;
> (b) where the premium (with or without automatic escalations) is not guaranteed for the full term of the policy but is subject to review after a period as contemplated in Rule 15, indicate the period for which the premium is guaranteed.
>
> *Balanced*
>
> 10.4.4 Descriptions in an advertisement must not exaggerate benefits or create expectations regarding policy performance or the performance of related services that the insurer does not reasonably expect to achieve.
>
> 10.4.5 Descriptions in an advertisement must include key limitations, exclusions, risks and charges, which must be clearly explained and must not be worded positively to imply a benefit.
>
> 10.4.6 Notwithstanding rule 10.4.5, but subject to all other requirements of this rule, where an insurer can demonstrate that, due to the nature of the medium used for the advertisement, it is not reasonably practicable for the information required in rule 10.4.5 to be fully included in the advertisement itself, the advertisement must:
> (a) indicate that additional information on key limitations, exclusions, risks and charges related to the product being advertised is available; and
> (b) where and how the additional information in (a) may be accessed.

[61] Rule 10.1 for both sets of rules defines "advertisement" as "any communication published through any medium and in any form, by itself or together with any other communication, which is intended to create public interest in the business, policies or related services of an insurer, or to persuade the public (or a part thereof) to transact in relation to a policy or related service of the insurer in any manner, but which does not purport to provide detailed information to or for a specific policyholder regarding a specific policy or related service".

[62] According to the definition "publish" means to make generally known, to make a public announcement, to "disseminate" to the public or to produce or release for distribution.

10.4.7 The information referred to in 10.4.6 must be publicly available and readily accessible to the average policyholder targeted by the advertisement.

Not misleading

10.4.8 An advertisement, when examined as a whole, must not be constructed in such a way as to lead the average targeted policyholder to any false conclusions he or she might reasonably rely upon. In considering the conclusion likely to be made, regard may be given to the literal meaning of the words, impressions from nonverbal portions of the advertisement (e.g. pictures, charts, diagrams, actions or expressions of actors), and from materials and descriptions omitted from the advertisement.

10.4.9 An advertisement must not obscure information. Each piece of information must be prominent enough in accordance with rule 10.15 and proximate enough to other information so as not to mislead the average targeted policyholder.

10.4.10 An advertisement must not be designed to exaggerate the need for urgency which could encourage the average targeted policyholder to make unduly hasty decisions."

The detailed provisions in the Second Draft PPRs aim to ensure that members of the public are not mislead. This is an important consideration in a country with low levels of financial literacy. It is also clear that complaints regarding advertising will be judged by considering the fairness and reasonableness of the insurer's conduct in the circumstances.[63] What *is* lamentable is the fact that if FAIS Ombud decisions, Enforcement Committee cases and court cases are anything to go by, there is insufficient evidence to show that more legislation is necessary. If anything, it misses the mark and will most likely stifle creativity in advertising.

3.5.3 Data management

Data management is a new aspect that will have to be included in all consumer legislation as the processing of personal information is now regulated by the Protection of Personal Information Act.[64] Both the first and second drafts of the PPRs deal extensively with this aspect and stipulate that insurers must have an appropriate data management framework. Rule 13 in the second draft of both sets of PPRs state unequivocally that data should be managed effectively and where a services provider is used to perform the insurer's data management functions, this too must comply with the new rule 13. It is submitted that this portion of the Draft PPRs is uncluttered and serves to protect the personal information of policyholders.

[63] For an example of problematic advertising, see *The Registrar of Short-term Insurance v Discovery Insurance Limited* case number 27/2015 where the Enforcement Committee fined Discovery for placing an advertisement that lured consumers into procuring their short-term insurance policies. More specifically, Discovery offered free insurance during the month of January to all those who used the Gautrain to commute to work and back. It stands to reason that many consumers are cash-strapped during January and will look for ways in which to save a few rands. Where such consumers then move their car insurance to Discovery purely to qualify for that saving of one month's premium, there is the danger that the Discovery product may in fact not be suited to their needs. As a result, Discovery was fined.

[64] 4 of 2013. For a general discussion on the scope of the Protection of Personal Information (POPI) Act, see Millard and Bascerano "Employers' Statutory Vicarious Liability in Terms of the Protection of Personal Information Act" 2016 *PELJ* 1.

3.5.4 On-going review of product performance

On-going review of product (line) performance is another new aspect that has been incorporated in the Draft PPRs. The first draft stipulated that a product *line* should be evaluated from time to time to establish whether the product together with ist disclosure documents "remain consistent with the needs of targeted policyholders and continue to deliver fair outcomes for policyholders".[65] The second draft contains rules on "product performance", having discarded "line". Essentially, rule 14 of the Second Draft PPRs is an improved version of the first draft and has substantially the same meaning.

It is submitted that product design is an aspect that did not enjoy sufficient attention in the past. In fact, many of the ills complained of and determinations issued by the FAIS Ombud pertained to so-called onerous clauses in insurance. Fitting of tracking devices to cars of a certain value, the meaning of "out and about" clauses, exclusion clauses and definitions of disability come to mind. It is submitted that an unintended consequence of the FAIS Act has been an emphasis on "advice", which resulted in a disproportionate burden on advisors and intermediaries to explain onerous clauses. While it may be argued that advisors and intermediaries are expected to be skilled, it is also true that products did not change much and few companies reviewed their policies with a view to drafting these in plain language. The relative importance of some of these onerous clauses should also be re-considered.

3.5.5 Conflict of interest

Conflict of interest is a long-standing feature of the FAIS Act. The first[66] draft of the two sets of PPRs duplicates what is already provided for in section 3A of the GCC in terms of the FAIS Act. This section, entitled "Financial interest and conflict of interest management policy" was promulgated in 2010.[67] It does appear that following public consultations, the second draft of both sets of PPRs scattered conflict of interest provisions between rule 11 that addresses disclosures,[68] rule 17 that contains stipulations on claims management[69] and rule 18 on complaints management.[70] In a sense, the re-packaging of conflict of interest provisions illustrates that the essence of such provisions is to ensure that a prospective policyholder is well-aware of any interest an advisor or intermediary may have in selling a particular product but also from a claims management perspective that the person responsible for claims management should ensure that there is no opportunity for allowing a conflict of interest that will adversely affect policyholders.

It is submitted that at the core, fairness underpins the imperative to avoid conflict between the interests of financial services providers and consumers.

[65] rule 15.1(a) and (b) (short-term PPRs) and rule 17.1(a) and (b) (long-term PPRs).
[66] proposed rule 19.3 of the long-term PPRs and rule 17.3 of the short-term PPRs.
[67] BN 58 in *GG* 33133 of 19 April 2010.
[68] rule 11.4.2(j).
[69] rules 17.3.1(b)(i) and 17.4.2(c).
[70] rule 18.4.2(c).

Products sold must meet the needs of consumers and should not serve the interests of services providers in any form. It is suggested that in light of the fact that the FAIS Act will be repealed, it is necessary to ensure that this very important aspect of market conduct regulation is retained. While there will in all likelihood be an overlap between the PPRs and the GCC for some time, the imperative to manage conflict of interest constitutes an indispensable part of consumer protection.[71]

3.5.6 Time-bar clauses

Ever since the Constitutional Court's decision in *Barkhuizen v Napier*,[72] opinion has remained divided on what constitutes fairness in time-bar clauses. The unsatisfacatory outcome of the case lead to an amendment of the current PPRs in terms of the LTIA and the STIA by ensuring more manageable time frames for the institution of claims against insurers. It is therefore not surprising that the First Draft PPRs published very detailed provisions on time-bar clauses, evidently suggesting an even fairer dispensation for policyholders.[73] This proposal conveys the idea that although there is no prohibition against the inclusion of time-bar clauses, it does place onerous duties upon insurers. One of these is the duty to either accept, repudiate or dispute a claim or the quantum of a claim within a reasonable time. Other duties include explaining a client's rights upon repudiation of a claim and providing details as to how to complain and how to approach the relevant ombud in terms of the Financial Services Ombud Schemes Act.[74]

It appears that although the suggested wording of the rule on time bar clauses in the second draft of both sets of PPRs have been altered, the essence of the first draft remains the same. Consequently, rule 17.6 entitled "Decisions relating to claims and time limitation provisions for the institution of legal action" stipulates as follows:

> "17.6.1 An insurer must accept, repudiate or dispute a claim or the quantum of a claim for a benefit under a policy within a reasonable period after receipt of a claim.
>
> 17.6.2 An insurer must within 10 days of taking any decision referred to in 17.6.1 in writing, notify the claimant in writing of its decision.

[71] On conflict of interest in general, see Millard and Hattingh (n 21) 121 and Moolman, Pillay, Bam and Appasamy *Financial Advisory and Intermediary Services Guide* (2010) 168.

[72] 2007 5 SA 323 (CC). See Kuschke "Barkhuizen v Napier" 2008 *De Jure* 464 463; Sutherland "Ensuring contractual fairness in consumer contracts after Barkhuizen v Napier 2007 5 SA 323 (CC) – Part 1" 2008 *Stell LR* 390.

[73] proposed rule 19.6 of the long-term PPRs and rule 17.6 of the short-term PPRs.

[74] 37 of 2004. In the past, the absence of lenient time-bar clauses and obligations on insurers to repudiate claims have led to serious miscarriages of justice. One such an example is *Muller v Sanlam Life Insurance Limited* (unreported case number 1162/2015; [2016] ZASCA 149 (30 September 2016)). *In casu* the insurer failed to accept or repudiate the claim, citing the unavailability of an inquest report. Several enquiries by the policyholder's broker revealed that Sanlam was still investigating the matter. Eventually the claim had become prescribed and on appeal, the court ruled that there was nothing in the particular contract that forced the insurer to repudiate or accept the claim within a specific time. Although the court was bound to judge the matter based on the contract between the parties, it is submitted that a rule against such unreasonable delay would have ensured a fairer outcome for the policyholder.

17.6.3 If the insurer repudiates or disputes a claim or the quantum of a claim, the notice referred to in rule 17.6.2 must, in plain language, inform the claimant –

(a) of the reasons for the decision, in sufficient detail to enable the claimant to dispute such reasons if the claimant so chooses;

(b) that the claimant may within a period of not less than 90 days after the date of receipt of the notice make representations to the relevant insurer in respect of the decision;

(c) of details of the internal claim escalation and review process required by rule 17.5;

(d) of the right to lodge a complaint to a relevant ombud and the relevant contact details and time limitation and other relevant legislative provisions relating to the lodging of such a complaint;

(e) in the event that the relevant policy contains a time limitation provision for the institution of legal action, of that provision and the implications of that provision for the claimant; and

(f) in the event that the relevant policy does not contain a time limitation provision for the institution of legal action, of the prescription period that will apply in terms of the Prescription Act, 1969 (Act No. 68 of 1969) and the implications of that Act for the claimant."

Further stipulations enhance the value of fairness in claims management and dispute resolution and it is suggested that these stipulations will reign in those insurance companies who have in the past used delaying tactics to avoid paying claims.[75] It is also expected that those insurers who have always handled claims fairly and expediently will simply formalise their practices and procedures.

3.5.7 Complaints management

Complaints management flows directly from claims management and the first draft rules introduced very detailed stipulations that emphasised the fact that unfair treatment of policyholders would not be tolerated. The inclusion of several definitions such as "complainant", "complaint", "compensation payment", "goodwill payment", "policyholder query", "rejected", "reportable complaint" and "upheld" does provide an unnecessary amount of detail but the focus on fairness is patently evident. These definitions have been included in the second draft of the two sets of PPRs. The obligation contained in rule 18.2 shows that insurers will in future be expected to have a proper complaints management framework. Engagement with the ombud is provided for in rule 18.11. This rule stipulates as follows:

"An insurer must –

(a) have appropriate processes in place for engagement with any relevant ombud in relation to its complaints;

(b) clearly and transparently communicate the availability and contact details of the relevant ombud services to complainants at all relevant stages of the insurance relationship, including at point of sale, in relevant periodic communications, and when a complaint is rejected or a claim is repudiated;

(c) display and/or make available information regarding the availability and contact details of the relevant ombud services at the premises and/or on the web site of the insurer;

[75] See rules 17.6.5-17.6.10 of the second draft of both sets of PPRs.

(d) maintain specific records and carry out specific analysis of complaints referred to them by the ombud and the outcomes of such complaints; and

(e) monitor determinations, publications and guidance issued by any relevant ombud with a view to identifying failings or risks in their own policies, services or practices.

18.11.2 An insurer must –

(a) maintain open and honest communication and co-operation between itself and any ombud with whom it deals; and

(b) endeavour to resolve a complaint before a final determination or ruling is made by an ombud, or through its internal escalation process, without impeding or unduly delaying a complainant's access to an ombud."

These stipulations build on existing rules on dispute resolution that are included in the GCC but at the same time impose new duties upon insurers. The rule as quoted above states very clearly that communications regarding complaints should be handled in a way that enforces procedural fairness. Insurers will in future be obligated to be very transparent in their communications regarding the details of the relevant ombuds and overall, communications should be open and honest.

It is submitted that there is a fine balance between providing access to justice while at the same time ensuring that justice is served. Unfortunately, there is often an irretrievable breakdown in communication between the insurer and the complainant and it is not necessarily as a result of the insurer's conduct. The FAIS Ombud often criticises financial services providers for not being co-operative and forthcoming with information.[76] It is therefore perhaps overly idealistic to take the stance that complainants are always right. It will also be difficult for insurers to "endeavour to resolve a complaint" while at the same time ensuring that a complaint to an ombud is not delayed.

3.5.8 Cooling-off rights

More detailed provisions on cooling-off rights provide inter alia that policyholders may cancel policies where no benefits have been paid or claimed and that this should be done within 14 days "after the date of the date of receipt of the policy contract".[77]

3.6 Conduct of Financial Institutions (CoFI) Bill

This much-awaited statute will complete the second phase of the Twin Peaks strategy. In a sense, this Bill is an empty vessel that is expected to be the final milestone on the road to TCF. As such, it will build on the existing market conduct framework contained in the FAIS Act and most notably the two sets of PPRs in its final format. This contribution has commented on overlaps between the GCC and the Draft PPRs and if one bears in mind that the GCC

[76] The most recent example is *Hylton Forge v Old Mutual Life Assurance Company South Africa Ltd* case number FAIS 03558/16-17 KZN 4. For a detailed discussion of this determination see Millard (n 42) 43-47.

[77] rule 5.1 of the First Draft PPRs for long-term insurance and rule 4.1 of the First Draft PPRs for short-term insurance.

will eventually be replaced by the final CoFI Act, it explains why there may be overlaps between the insurance statutes during this transitional phase. This is an unintended consequence of these complex legal reforms that serves to cause great confusion at present. Bearing in mind the ultimate aim of consolidating all maket conduct rules in the final CoFI Act enables one to makes sense of duplications and overlaps, especially since the PPRs will be repealed together with the enabling legislation (the LTIA and the STIA)

4 *Evaluation of legislative reforms*

4.1 General

The decision to separate prudential and market conduct regulation will no doubt have a serious impact on the insurance industry. Where in the past the LTIA and STIA contained prudential and market conduct regulations, The Insurance Act, when promulgated, will in future regulate prudential matters only while the CoFI Act will regulate market conduct. This is a very simplified view of the road to Twin Peaks. The establishment of a prudential and market conduct regulator will no doubt be costly and it is in all likelihood too soon to say whether these costs are justifiable.

4.2 Inclusion of TCF principles

The inclusion of the TCF principles in the PPRs as an interim legislative measure is arguably the most useful reform to date. It is not only the explicit listing of these principles that convey the idea that the harsh effects of *pacta sunt servanda* in insurance contracts will be tempered, but also the infusion of fairness in all those problematic aspects pertaining to the insurance business, contracts, claims and claims procedures.

The most logical aspect of TCF as a values-based concept is the fact that it introduces the product-life cycle. For most insurance products (save perhaps non-advice, off-the-shelf policies), this life cycle includes product and service design, promotion and marketing, advice, point of sale, information after point of sale and complaints and claims handling.

The Second Draft PPRs (paragraph 3.5.1 above) provides for some of these aspects. *Product service and design* is provided for in rule 2, *promotion and marketing* in rules 10 and 11, and *complaints and claims handling* in rules 17 and 18 of both sets of rules.

This analysis through the lense of the product life cycle reveals that *advice,*[78] *point of sale* and *information after point of sale*[79] still fall squarely within the realm of the FAIS Act and GCC and common-law principles of agency. There is also an overlap between these stages and in practice, several activities constitute advice, the actual sale and after-sale service.

As was indicated in the discussion of the CoFI Bill, this Bill, once law, will consolidate these rules. It is suggested that a sensible way of drafting the CoFI Bill will be to follow the process as set out in the product-life cycle as it will be user friendly. By grouping together all the rules pertaining to the various stages, together with exceptions to these and exclusions, the CoFI Bill can successfully establish a sound market-conduct framework.

5 *Conclusion*

That the legislature has good intentions goes without saying. It is submitted that the Insurance Act, once promulgated, together with the CoFI Act, will complement each other, constitute a solid legal framework and avoid duplication. It does however provide the legislature with a vessel to fill with all those aspects of market-conduct regulation that will in the meantime remain in the PPRs and in the FAIS Act. Overall, the Insurance (Act), together with TCF in the proposed PPRs and the much anticipated CoFI Act constitute important milestones on the way to Twin Peaks. The road may be long and winding but the destination is clear.

[78] Current sections of the FAIS Act that regulate advice include s 6A (Fit and proper requirements) and s 8A (Compliance with fit and proper requirements after authorisation). Stipulations in the GCC include s 2 (General duty of provider), s 3 (Specific duties of provider), s 5 (Information on providers), s 6 (Contacting of client), s 7 (Information about financial service), s 8 (Suitability of advice) and s 9 (Record of advice). A number of Ombud determinations have enforced these rules. See *eg David Marthinus Adlen v Herman Coertzen Brokers CC and Herman Bernardus Coertzen* (case number FAIS 05054/12-14/GP2*)*; *Charles Spencer Griffiths v Alwyn Smit Finansiële Dienste BK and Alwyn Bernardus Smit* (case number FAIS 05659/11-12/WC1). See also *Juduth Augusta Theophield Eduard Campioni-De Vleesshauwer v Suzette Brickhill and Mathys Johannes Marais t/a Protea Makelaars* (case number FAIS 04437/11-12/LP3). In this case, the complainant was advised by Brickhill to procure short-term insurance with Santam and that she needed to pay a year's premium in advance. Instead of securing insurance on behalf of the complainant, she kept the money and forged a policy schedule. The complainant discovered this when she tried to institute a claim and the Ombud ruled in her favour, citing breach of s 2 of the GCC as well as ss 17(1)(a) and 17(3) of the FAIS Act.

[79] See *eg* s 10 of the GCC (Custody of financial products and funds).

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Trade digitization: developments and legal aspects

THANDIWE LEGWAILA*

1 *Introduction*

Everyday life has been transformed by digitalization, and most industries are similarly being overhauled by technological developments. The transformation of trade finance has not happened at the same pace. In an era of slow trade growth – and at a time where the trade finance gap is at its largest and most crippling[1] – trade finance ought to accelerate its own digitization journey. Trade growth has not recovered much since the global economic crisis. In the 2017 ICC *Global Survey on Trade Finance* nearly 80% of survey respondents expressed the view that traditional trade finance will exhibit little or no growth, or decline outright year-on-year. Global trade overall has not recovered to the levels before the 2008 global economic crisis. The drop in oil prices since 2015 has had a ripple effect on the slow trade growth; more so in economies that depend on oil exports. So how can digitization aid trade growth?

International sanctions and the anti-money laundering, counter-terrorism and KYC regulations are also forcing changes to business models. Banks are required to complete increasingly complex checks on trade transactions, while accelerating turnaround times without incurring higher costs or transaction errors.[2]

The notion that the paper-based office is on its way out has had currency for a very long time. Proponents of the digital alternative have tried to promote the cause through a number of angles including efficiency, security, cost and faster turnaround times. However, paper's grip on trade finance seems more tenacious than anyone would have thought, given the availability of new digital ePresentation tools and Fintech solutions capable of answering the needs of most trade ecosystem players.

One could argue that perhaps the slow pace of change is driven by the uncertainty of the digital world. The well-established ICC rules such as UCP600, URDG758, ISP98 and URC522, have for a long time provided certainty of what is to be expected and counterparties are comfortable with the paper-based and process-driven trade finance. The above-mentioned survey records that it is expected that commercialized digital flows are first expected in Advanced Asia economies and Western Europe.[3] In my view African economies will definitely

* West Africa Product Head, Transactional Products & Services, Standard Bank of South Africa.

1 ICC *Global Survey on Trade Finance* (2017).

2 PWC "Anti-money laundering and counter-terrorism financing: from compliance to confidence" (http://www.pwc.com.au/consulting/assets/anti-money-laundering-2017.pdf).

3 n 1 above.

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follow. One just needs to look at the mobile money adoption in the African market in an attempt to move away from physical cash. Mobile money adoption in Africa outpaced growth in the rest of the world, with over half of all services globally and more than 40% of adults in active use located there.[4]

International trade has for many hundreds of years relied upon a full set of documentation to ensure the dispatch, shipping, offloading and receipt of goods by the paying customer. Such a requirement is starting to change with a move to digitization; the trigger event will not change, what will change is the form that evidences that a leg of a transaction has been fulfilled or the form evidencing rights to goods. This is so even in the developing economies such as South Africa where in my view not so much attention has been drawn to the modernization of the legal framework and technology already available to make this possible. The trade digitization developments in South Africa will be discussed later in this paper. Currently the trade world is shifting from paper to electronic and in doing so is ushering in an era of vastly improved trade facilitation across the trade ecosystem.

This contribution will discuss the challenges of the current paper-based trade finance ecosystem, share some of the developments in trade digitization and look and the drivers for change.

2 *Paper-based trade finance examined*

Imagine a trade arrangement where the importer and exporter conclude a supply agreement and there is an exchange of physical agreements wherein they agree on the terms of payment, supporting trade documentation, rights and obligations under the contract and other necessary terms and conditions governing their agreement.

Suppose the parties agreed on a letter of credit ("LC") as terms of payment. The importer would raise a purchase order, send it to the exporter and the exporter would accept the purchase order and demand the issuance of an LC. The importer would approach its bank and apply for credit facilities in order to issue the LC. The bank would examine the importer's balance sheet, assess the importer's working capital cycle and satisfy itself on the importer's ability to settle the LC when it falls due and payable. If the credit facilities are approved by the bank (which is a process that could take a couple of weeks) the client would then complete an application form with the banks' terms and conditions (which at times contains lengthy indemnity clauses and disclaimers), and send the application form either through the bank's frontend platform, but mostly by email, or would hand deliver it to the bank in markets that still require sight and retain original documents. The latter is almost always the case in less developed African markets.

On receipt of the application form on the bank's side, the form is examined to assess whether the application form has been signed by authorized signatories in

[4] Gahigi "Mobile money is only just starting to transform some of Africa's markets" (27 July 2017) (https://qz.com/#1039896/m-pesa-mtn-orange-others-lead-africas-mobile-money-revolution).

order to prevent fraudulent transactions. Financial institutions who fail to fulfil this duty have been exposed to losses as it is expected of the bank to exercise a duty of care when handling these transactions.[5] An issuing bank can be induced to open a credit by fraudulent misrepresentation. The Court of Appeal in the case of *Solo Industries UK Ltd v Canara Bank* held that unless fraud was established, any claim a bank might have against a beneficiary making a fraudulent demand must be pursued separately following payment, and cannot normally be used as a defence or set-off to avoid payment.[6] As a result of this risk, banks have put in place processes and manpower to avoid missing unauthorised signatories or fraudulent instructions. This is a requirement that could be met easily if digital solutions were to be put in place to validate authorised signatories.

Over and above verifying the authenticity of the application forms the banks also conduct compliance checks such as KYC, anti-money laundering, FAIS, POPI; and also in respect of international sanctions with regard to the Office of Foreign Assets Control ("OFAC") and the United Nations Security Council ("UNSC") – over and above the checks that are done automatically by SafeWatch, which is a SWIFT certified filtering web-based solution composed of a series of tools targeted at AML detection, serving as a checking point for an institution's financial traffic.[7]

The Financial Intelligence Centre Act 38 of 2001 ("FICA") in conjunction with the Prevention of Organised Crime Act 121 of 1998 ("POCA") form the backbone of South Africa's anti-money laundering regime. Like its international counterparts FICA imposes onerous duties on banks seeing that they are most often used by criminals as conduits to launder the benefits of crime. Failure to meet these compliance requirements has also exposed banks to fines.[8] As such banks have put systems in place and increased the headcount in their processing environments to avoid missing prohibited transactions. This response to the compliance requirement has lengthened the transaction processing time resulting in delays in trade turnover.

If the bank finds that the transaction complies with the bank's qualifying criteria the LC is captured on the bank's systems and goes through levels of release approvals depending on the transaction amount and risk levels. Most trade operation environments apply the two to four eye principle to mitigate against human error. For example, capturing the transaction amount incorrectly, or transaction details incorrectly, exposes the bank to huge financial risk as the bank is held liable once the MT700 message is sent to another bank and it cannot be unilaterally retrieved or amended without the consent of all parties to the transaction.[9] This step on its own delays the transactions as it is dependent on a human touch to move the transactions.

[5] *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578

[6] n 5 above.

[7] EastNets "en.SafeWatch Filtering Real-Time Watchlist Screening" (http://www.eastnets.com/Files/EastNets_en%20SafeWatchFiltering_A4.pdf).

[8] fin24 "Sarb fines 5 SA banks a whopping R30m" (5 August 2016) (http://www.fin24.com/Economy/just-in-sarb-fines-5-sa-banks-a-whopping-r30m-20160805) and see n 2.

[9] Warren and Walt *Commercial Law* (2008) 85.

In the absence of integrated platforms where clients' instructions are processed and automatically transmitted to banks' backend systems that automate the due diligence, the issuance of an LC from a client to the export bank can take a couple of days, delaying the movement of goods.

3 *Trade finance – a progressive move towards digitization*

In light of the heavy operations process involved in issuing an LC and the associated costs, international banks are under pressure to review their trade finance business models, organizational structure and processes at the back of drop-in product profitability, increased country risks and increasing regulatory compliance requirements. Various factors such as the decrease in trade, the decline in the letters of credit business[10] and drop in commodity prices are intensifying the competition between trade finance banks, forcing banks to review their business models and better manage, anticipate and mitigate changing levels of country risks in the context of lower profitability.

Despite the pain that is known and acknowledged by trade ecosystem players and the availability of existing solutions, a chain is only as strong as its weakest link and in the trade documentation space the whole suite of ePresentation tools working in harmony can still grind to a halt if, as is often the case, local customs and excise officials demand to see paper documentation.

Notwithstanding entrenched local practices, serious inroads into digitization have been made in many countries. At the specific document level there has been progress with certificates of origin used in agri-business, veterinary or export health certificates used when shipping livestock, and the Shipper's Export Declaration for export control of items over a certain value (the latter is now known as an Electronic Export Information Filing.[11] Further progressive solutions have been developed by technology infrastructure providers such as SWIFT, Bolero, essDOCS and GTC. The offering of these platforms is discussed briefly below:

a) Bolero International

Bolero is a multi-bank trade finance and electronic trade documentation offering. Its software-as-a-service (SaaS) delivery model provides trade solutions for corporates in two key areas, namely the multi-banking trade finance applications and the electronic presentation of trade documentation. The idea in the first instance is to provide a single platform multi-bank electronic trade finance management tool for traditional trade instruments. Bolero also aims to dematerialize trade documentation, enabling end-to-end flow for trade under LC, open account and the BPO (discussed below).[12]

[10] ICC *Global Survey on Trade Finance* (2016).

[11] Treasury Today "Digitisation of trade documents" (September 2015) (http://treasurytoday.com/handbook/treasurers-guide-to-digitisation/section-04).

[12] Bolero "The Bolero Electronic Bill of Lading (eBL) Overview" http://www.bolero.net/files/downloads/eBLOverview.pdf and United Nations Commission on Intrnational Trade Law *Yearbook* Volume XXXII: 2001 289.

b) essDOCS

essDOCS dates back to 1986 in its first incarnation as the Seadocs (Seaborne Trade Documentation System) project and was the first significant attempt to use electronic documentation for goods carried by sea. Having ironed out early legal issues, essDOCS today is one of the largest providers of electronic bills of lading globally (it claims adoption by more than 2100 companies across 65 countries). essDOCS Exchange is its main multi-bank platform whilst its CargoDocs function enables banks and corporates to combine electronic bills of lading and supporting documents with eUCP Presentation, eDocumentary Collection and the BPO.[13]

c) GTC

GTC offers a web-based multi-bank trade finance platform for corporates and banks. The @GlobalTrade offering allows the transfer of all eUCP electronic trade documents including LCs, import and export documentary credits and collections. GTC also offers a solution for connectivity between applications within the ERP systems of corporates and the back-office systems of banks and trade service providers.

d) Mt798 – the Trade Envelop

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.[14] 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.

e) TSU and BPO – a data matching and financing solution

The Bank Payment Obligation ("BPO") is another recent digital innovation. It provides the benefits of an 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.[15] A 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.[16]

[13] Trade and Supply Chain @ Sibos, 2011.
[14] SWIFT "Drive trade digitisation" (https://www.swift.com/our-solutions/corporates/drive-trade-digitisation/mt-798).
[15] ICC "Bank Payment Obligation" A Banking Commission Supply Chain Finance project (http://icc.tobb.org.tr/docs/Bank%20Payment%20Obligation.pdf).
[16] n 13 above.

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. 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.[17]

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 trace of subjectivity attached to data matching is removed, eliminating the risk of human error. At the back of this digital solution the International Chamber of Commerce (ICC) launched Uniform Rules for Bank Payment Obligations ("URBPO") to govern transaction processes under this solution.

It is evident just on the above-mentioned technology solutions that the whole trade ecosystem is spoilt for choice when it comes to transformation of the trade environment. Regardless of the settlement instrument, the requirement in today's trade is to place in the hands of the buyer the original trade documentation as soon as possible to enable the importer to clear the goods at the port. Most notable of these is the bill of lading, which evidences receipt of goods for shipment, their delivery and legal title, and without which banks will not release payment. Therefore, the speed at which paper- based shipping documents physically move along the value chain slows down trade and at the same time exposes the importers to demurrage charges where the goods arrive at the port of destination before the papers make it to the importer bank.

The UK arm of the global shipping industry's carrier insurance scheme, run through P&I (protection and indemnity) Clubs, acknowledges that "non-availability, or non-production, of a bill of lading is becoming more common". Delays can be costly for all parties, not least the shipping company, which has to decide what to do with the goods as it waits in port. Clearance of cargo without a bill of lading can be expedited with a Letter of Indemnity ("LOI"), however, these tend to be seen as problematic by the P&I Clubs, largely because there have been a number of fraudulent uses of these paper documents over the years. For high-value cross-border LCs, BPO or open account trade, the electronic bill of lading and the ability to notify and present on the LC electronically is what the above-mentioned platforms are aiming for.

The arrival of the electronic Uniform Customs and Practice for Documentary Credits ("eUCP"), issued by the International Chamber of Commerce ("ICC"), has been instrumental in gaining credibility for ePresentation. The UCP is a set of standardised processes for the issuance and use of letters of credit used across the world. The "e" version is a supplement brought into being as banks, corporates and the transport and insurance industries started to adopt electronic processes. The first issuance of a paperless LC subject to eUCP was in 2010,

[17] n 8 above.

between an Australian mining company and a Chinese buyer, and facilitated on the Bolero platform.[18] The documents in the ePresentation included the commercial invoice, packing list, certificate of weight, certificate of analysis, the bill of lading and the insurance certificate. The ability to transmit trade documents from exporter to importer bank and ultimately to importer for goods clearing is powerful. The acceptability of these electronic formats is even more powerful, eliminating the need of producing physical documents at some point.

3 *How is digitization progressing in the trade finance space? A view in the South Africa context*

In theory, the preparation, dispatch and receipt and storage of electronic documents facilitate cost savings and process efficiencies whilst reducing the potential for fraud. Today in South Africa it is possible, on the basis of existing technology and under the existing legal framework, to replace bills of lading by electronic documents, which can in principle afford to the parties security at least as great as existing paper documents.

The Electronic Communications and Transactions Act ("ECTA")[19] governs the admissibility of electronic documents in court. The ECTA was enacted to alleviate confusion arising from areas of uncertainty between an original and copy of an electronic document or data message. Its purpose is to

> "provide for the facilitation and regulation of electronic communications and transactions; to provide for the development of a national e-strategy for the Republic; to promote universal access to electronic communications and transactions and the use of electronic transactions by SMMEs; to provide for human resource development in electronic transactions; to prevent abuse of information systems; to encourage the use of e-government services; and to provide for matters connected therewith".

The Act aims at facilitating regular electronic communication and at increasing use of electronic transactions and to prevent information abuse. The most significant impact of this Act is that courts are now able to confirm whether the data message remains unaltered when presented as evidence in court. According to section 14 of the Act the data message meets the legal requirements of being presented or retained in its original form if:

> "(a) the integrity of the information from the time it was first generated in its final form, as a data message, has passed an assessment on whether the information has remained complete and unaltered in the purpose for which the information was generated, taking into account all circumstances surrounding the information and medium used and purpose; and
>
> (b) that the information is capable of being displayed or produced to the person to whom it is to be presented."

Furthermore, section 27 of the ECTA provides for the acceptance of electronic filing and issuing of documents and states that:

[18] Branch *Export Practice and Management* (2006) 462.
[19] 25 of 2002.

"Any public body that, pursuant to any law-
(a) accepts the filing of documents, or requires that documents be created or retained;
(b) issues any permit, licence or approval; or
(c) provides for a manner of payment may, notwithstanding anything to the contrary in such law–
  (i) accept the filing of such documents, or the creation or retention of such documents in the form of data messages;
  (ii) issue such permit, licence or approval in the form of a data message; or
  (iii) make or receive payment in electronic form or by electronic means".

In addition to this the International Organization for Standardization developed ISO 15801, which has been adopted in South Africa in 2005 as SANS 15801,[20] providing some framework within which companies can operate and ensure confidence that records will meet the ECTA requirements of authenticity. The following important elements are required by SANS:

(i) Scope of Policy: companies must have well designed and implemented policies;
(ii) Duty of care: this principle does not only apply to electronic documents but across the organisation, relating to how people perform their job functions, how authority is delegated and the separation of responsibilities to reduce collusion and the potential of fraud;
(iii) Procedures: must cover all aspects of imaging from the time documents arrive at the organisation and are prepared, scanned, indexed, stored, retrieved and reproduced on some output device such as a screen or printer;
(iv) Enabling technology: image enhancement, character recognition and digital signature technology;
(v) Audit trail;
(vi) Documented processes: processes must be properly documented and detailed in procedure manuals and maintenance schedules.

I therefore submit that in South Africa the legal issues with the digitization of trade documentation have by and large been dealt with. Key industry players in South Africa such as the SARS have embarked on Custom Modernisation initiatives which has put trade with South Africa at an advantage. The Customs Modernisation Programme is the product of almost ten years of research and planning. It commenced with the investigation, research and re-writing of the customs legislation. SARS' accession to the World Customs Organization (WCO) and the Revised Kyoto Convention in 2014[21] required Customs to make some significant changes to its business and processing model. These changes included the introduction of simplified procedures that had a fundamental effect and benefit for South Africa.[22] To achieve this expectation, Customs

[20] South African Bureau of Standards SANS 15801:2005 *Electronic imaging - information stored electronically - recommendations for trustworthiness and reliability* (http://www.scanco.co.za/PDF/SANS_15801.pdf).

[21] World Customs Organization "The Revised Kyoto Convention now has 101 Contracting Parties following the accession of Thailand and Sierra Leone" (http://www.wcoomd.org/en/media/newsroom/2015/june/the-revised-kyoto-convention-now-has-101-contracting-parties.aspx).

[22] "Implementation of the new Customs Systems Modernisation Programme" (22 August 2013) (http://www.sars.gov.za/Media/MediaReleases/Pages/22-August-2013---Implementation%20of%20the%20new%20Customs%20Systems%20Modernisation%20Programme.aspx).

introduced modern IT solutions and amendments to existing legislation, and its new integrated technology solution has been designed according to the following objectives:

I. Simplification and harmonisation of Customs procedure.
II. Standardisation of customs procedure across trade modalities (air, sea, rail, land).
III. Automation of key customs processes – import/export customs clearance, advance electronic notification of impending goods arrival/departure, and secure recording of goods movements.
IV. Expedited clearance formalities for specific classes of goods according to an importer/exporter's standing (risk profile) with SARS. This could enable:
  a) Clearance of goods either orally, or without a formal customs clearance; or
  b) Clearance of goods via an incomplete or provisional declaration, subsequently followed by a supplementary clearance revealing final/correct information.[23]

The above are designed to streamline the Customs clearance process and offer an improved experience and service to the trader. An integral part of the new Customs process is the introduction of a proper automated risk management system. Without risk management, Customs would be bound to check each and every consignment entering or leaving the Republic. These developments allow freight forwarding clearing agents to submit logistics documents in electronic format. What then will stop banks from accepting electronic forms of bills of lading, inspection certificates, certificates of origin and commercial invoices called for in an LC? It is said that over 93% of documents are initially created and stored in an electronic format and over 30% of those are never printed.[24] If these documents adhere to the ECTA, ISO and SANS standards and requirements why can they not be transferred, acted upon and stored as evidence in electronic format?

The persistent perception that electronic documents are somehow less secure than paper and that they are open to abuse by cyber-criminals can be dealt with by the sophistication of modern technology and security features they provide. Of course, there is an element of vulnerability with all electronic systems but few could surely believe that a fully encrypted document is less secure than its paper equivalent in terms of authenticity, reliability, and originality.

I however concede that in less developed markets in particular in Africa where the legal system does not have the equivalent of an ECTA and does not recognize electronic documents in the same way they recognize original documents a lot of work has to be done to modernize and transform the legal system. Changes may be required in those jurisdictions to the rules on personal data protection, admissibility of computer-generated documents in court, and the transmission of encrypted data across national boundaries. Key to the transformation of

[23] See n 22.
[24] Van Dorsten "Discovery of electronic documents and attorneys' obligations" November 2012 *De Rebus* 34-36.

these markets is the adoption of international trade treaties such as the World Customs Organization (WCO) and the Revised Kyoto Convention in 2014 which will pave the way for markets and propel the countries to look at their local regulations relating to customs law, electronic transaction laws, recognition of digital signatures, privacy and security laws.[25]

I submit that in South Africa we have already crossed this bridge and banks and the trade ecosystem players such as logistic companies and cargo carriers must be proponents of the trade finance transformation and advocates for the acceptability of digital information in the same way as an original. But this requires some investment in technology enablement which a number of Fintech companies have built and brought to market; it is now a matter of adoption. Below I will now look at how digitized trade finance potentially looks like.

5 *Within the bank – internal bank trade process and documents digitization*

Regarding documentary trade finance, a first step could be for banks to improve their processing efficiency to reduce costs and increase security by using new technologies to digitize paper and enable operating processes and compliance checks to be optimized. Such a project is manageable because it is internal to a bank and does not depend on third parties. The return on investment of such an approach is likely to look attractive as the banks will be able to turn around transactions much faster with less human intervention, meaning that some back-office staff can be deployed in the client space for business sales or better deployed elsewhere in the bank.

Many actors have already taken this first step by implementing electronic document management (“EDM”). The next step is to use the data that has been scanned and this involves OCR technologies and image recognition, artificial intelligence and machine learning, and data manipulation algorithms.

Against this backdrop in a perfect digitized trade transaction, in the export LC scenario, the exporter would ship the goods and apply for an electronic bill of lading to be issued by the carrier, with which the exporter would transmit the necessary documents electronically to the presenting bank (exporter bank). The presenting bank would check the documents against the relevant LC and forward the documents electronically to the issuing bank, which would in turn check the documents to ensure compliance with the terms and conditions of the LC before making the payment. The issuing bank would then forward the documents electronically to the importer and its clearing agent who would use the documents for obtaining clearance of the goods when they arrive. Throughout the transaction, the various parties would log into the same platform for access to the documents and for forwarding the documents to the next party.

In the import LC scenario, the importer would use an MT798 SWIFT message, send an application to the bank and transmit digitally supporting documents that have to be sighted by the bank before issuing the LC; the bank would then

[25] World Trade Organisation *Key Factors in Establishing Single Windows for Handling Import/Export Procedures and Formalities:* Trade Facilitation and Single Window, UNESCWA (2011) (https://www.wto.org/english/tratop_e/tradfa_e/case_studies_e/escwa_e.pdf).

receive the LC request already in SWIFT format into its banking systems and processing system which are integrated with a compliance check engine, and if the transaction passes the compliance checks, the LC is automatically issued to the issuing bank and at the same time a copy of the LC is sent to the bank's client through SWIFT or the client's preferred means. This digitized process takes days away from the transaction processing time, meeting the client's expectations whilst reducing transaction-processing costs.

6 *Development in the global corporates and trade logistics players space*

At the most basic level, commercial and corporate clients are looking for risk mitigation, financing and settlement solutions that can keep up with the accelerating pace of the conduct of international business, both in the decisioning dimensions and in the transaction execution dimensions of the overall propositions. A good number of corporates have automated their environment. Their ERP systems talk to each other at a global level; the integration with banks being its key for the end-to-end execution and efficiency. The last thing sophisticated treasuries want to do is to complete a physical application form and send it physically to the bank without transactions recorded and monitored in their ERP systems or systems connected to their ERP systems.

From the trade logistics side looking at the clearing agents, forwarding agent, port authorities and Customs, the application of technology and the pursuit of digitization solutions extend to various areas in international business, trade and investment, including supply chain management and optimisation and so-called "Single Window" market access programs. These programs are undertaken as part of trade facilitation policies, aiming to make the pursuit of trade opportunities more efficient and cost effective by developing technology-enabled portals that allow for easy and prompt Customs clearance, logistics management and related activities that must be completed, to allow a product to enter its destination market.

Under the WTO accord the General Agreement on Tariff and Trade ("GATT"), Articles V, VIII and X aim at reducing Customs fees, reducing, and eventually eliminating, non-tariff barriers ("NTBs"), reducing the cost of red tape and ensuring transparency in trade transactions.[26]

In addition to the ramifications of international trade treaties, there are local regulatory impacts which need to be reflected in national trade-related legislation, and in legislating the technologies that enable international trade transactions to be automated.

In light of the SARS modernisation project giving effect to these treaties I submit that South Africa meet this hurdle and nothing should prevent South African trade ecosystem players, port authorities, Customs and banks from digitising their trade processes, thereby streamlining trade with Africa.

[26] Hartzenberg *et al The Tripartite Free Trade Area: Towards a New African Integration Paradigm?* (2012) (http://www.tralac.org/wp-content/blogs.dir/12/files/2012/05/TFTA-towards-new-African-integration-paradigm-20120419-finalweb.pdf).

7 *Digitalisation vs digitization – blockchain the end game*

What blockchain technologies promise is the instant movement of data (not just the movement of electronic documents, which is considered as digitization) from one part to the other reducing decision and product processing time and thereby shortening the trade transaction life-cycle. Data visibility, complex analytics and a shift from transaction-based value to information-based value will follow, and the ability to extract, manipulate and benchmark data that would originally have been found only in hardcopy documents will be an important cornerstone of the way business is conducted, risk is mitigated, and commercial transactions will be financed on a cost-effective, global and near-real time basis.

8 *Conclusion*

The level of appetite among corporates to adopt full ePresentation depends on a number of variables, such as whether the corporate is an exporter or an importer, the volume of transactions or the type of goods. BPO is largely confined to the huge commodities traders at the moment because the volumes and values (and risks) justify the costs of supporting the software and architecture. The users of multi-bank platforms such as those mentioned above are many in number and momentum is gaining. Despite the massive technological advances in the interim period, paper-based trade is still common. For the use of ePresentation to be fully accepted in the export space, alignment of all involved parties is necessary.

My submission is that initiatives such as electronic document presentment by Bolero and essDOCS blockchain start-ups such as Wave have paved the way for digitization. This should create a less paper-intensive world as documents are transmitted in real time between importers, exporters and banks. A consequence could be a dramatic reduction in the number of cargo carrier letters of indemnity, which importers have to issue when trade documents are lost or delayed. Documents will arrive before the goods, which avoid demurrage costs and enables buyers to get their goods faster.

Concerning Blockchain, this technology solution still requires standardization and strong governance, which will be very important for adoption. The ICC working group on digitalization of trade finance will provide good direction in this sphere.

In my view banks should lead the way and partner with lawmakers, port authorities, Customs authorities and Fintechs and most importantly, corporate clients, to drive the digitization agenda. This can firstly be achieved at a national level in the same way that South Africa has done and expand it to a regional level, leveraging lessons in South Africa and developed markets.

The fundamental question remains: will financial institutions, as traditional providers of trade financing solutions around the world, perceive the shifting tide early enough, and react quickly and decisively enough to be seen by clients as having understood, internalised and acted upon the changing needs and expectations of the market?

Company and corporate insolvency law update

KATHLEEN VAN DER LINDE*
FAADHIL ADAMS**

1 *Introduction*

Company law issues have occupied a large amount of the time of our courts since the previous ABLU in October 2016. For two consecutive years now company law cases found themselves before the highest court in the land.[1] Aside from a number of cases on remedies, we consider cases on directors' duties and their personal liability, subscription for shares, the right of shareholders to participate in meetings, the effect of re-registration on the property of a deregistered company, and even a ruling of the takeover regulation panel. We also deal with business rescue. On the insolvency side there were important cases on insolvency practitioners,[2] but since they are being appealed we do not address them this year.

2 *Remedies*

Six years after the commencement of the "new" Companies Act 71 of 2008,[3] the interpretations and the differences between these remedies in their previous manifestations under the Companies Act of 1973 and their current manifestation in terms of the Companies Act of 2008 continue to be relevant.

2.1 The oppression remedy

When one is faced with an update involving multiple cases of significant import, the hardest question is where to begin. Courtesy would dictate that seniority would be the order of the day and as such we begin our discussion with the judgment the constitutional court in *Off-beat Holiday Club v Sanbonani Holiday Spa Shareblock Ltd*,[4] delivered by Justice Mhlantla with Justices Nkabinde, Cameron, Jafta, Khampepe and Zondo concurring. The judgment is important

* Professor of Corporate Law, University of Johannesburg.
** Lecturer, Department of Mercantile Law, University of Johannesburg.

[1] *Makate v Vodacom (Pty) Ltd* 2016 (4) SA 121 (CC).

[2] *Minister of Justice and Constitutional Development v South African Restructuring and Insolvency Practitioners Association* 2017 3 SA 95 (SCA), declaring unconstitutional the master's policy for the appointment of insolvency practitioners, and *Diener NO v Minister of Justice* (30123/2015) 2016 GP which dealt with the claim of a business rescue practitioner when the company is subsequently liquidated.

[3] References to section numbers in this update are to provisions of this act, unless indicated otherwise.

[4] 2017 7 BCLR 916 (CC).

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for its interpretation of a "debt" for the purposes of section 10(1) read with section 11(d) of the Prescription Act of 1969. [5] It will be recalled that following the Constitution Seventeenth Amendment in 2013,[6] the highest court is allowed to consider not only matters that are constitutional in nature but also matters that are in the public interest. The two company law cases that have come before the constitutional court in the last two years are related as *Off-beat Holiday Club* involves an interpretation of principles laid down by the court in *Makate*.[7] The supreme court of appeal judgment in *Off-beat Holiday Club* was handed down before *Makate* was decided by the constitutional court. A factor of significant import is that the supreme court of appeal relied on *Desai*.[8] *Makate*, however, concluded that the test in *Desai* was inappropriate to the extent that it deviated from *Escom*.[9] The constitutional court thus had an interest in hearing this matter as it is a matter concerning its own interpretation.

The background forming the dispute can be traced back to 1991 at which time Off-beat Holiday Club and Flexi Holiday Club (the clubs) became minority shareholders in Sanbonani Holiday Spa Shareblock Ltd (Shareblock). Together the clubs controlled 29.14% of the shareholding in Shareblock.[10] Shareblock operated a shareblock scheme that was developed by Sanbonani Development Limited (Development). Harri owned 46.7% of Shareblock's shares and, through a trust, 80% of the shares in Development. In 1999 disputes arose because of the manner in which Shareblock was run by Harri in particular due to two acts conducted by Harri. The first related to a value added tax refund that was paid to Development but should rightly have been paid to Shareblock, while the second was in relation to the use of certain common property.[11] Further disputes arose in 2004 regarding the composition of the board of directors of Shareblock, an amendment of its articles of association and the allocation of shares. It was these acts that finally led the clubs to launch proceedings to obtain a declaratory order that the creation and allocation of shares were invalid and that the offending articles should be cancelled.[12] An example of the orders sought in the notice of motion is repeated here because of their central importance to the overall issue:[13]

> "(a) An Order declaring the following to be invalid:
> (i) article 3.5 of the First Respondent's articles;
> (ii) the allocation of more than 1040 shares to share block 65SBPC relating to site 56 of the First Respondent;
> (iii) the creation of share blocks 57 to 60 SBCF and 61 to 63SBCP in the Articles of Association of the First Respondent;
> (iv) the creation of share blocks relating to 'Maintenance weeks' and the allocation of shares pursuant thereto;

[5] par 24.
[6] more specifically the insertion of s 167(3)(*b*).
[7] par 23.
[8] *Desai NO v Desai* 1996 1 SA 141 (SCA).
[9] *Electricity Supply Commission v Stewarts and Lloyds of SA (Pty) Ltd* 1981 3 SA 340 (A).
[10] par 4.
[11] par 6.
[12] par 9.
[13] par 59.

(b) An Order that the articles of the First Respondent are amended in the following respects:
(i) deleting the word 'issued' and substituting therefor the word 'allocated' in article 3.1 so that it will read as follows: 'The authorised share capital of the company is divided into: 168 528 (one hundred and sixty eight thousand five hundred and twenty eight) ordinary shares of Rl,00 each of which 168 528 (one hundred and sixty eight thousand five hundred and twenty eight) ordinary shares of Rl,00 each have been allocated as set out in Annexure "A" conferring rights of use as set out in articles 3.2 and 3.3, 3.4 and 3.5, appointed between 63 Share Blocks, numbered 163".

These claims were based on section 252 of the Companies Act of 1973, the predecessor of section 163 of the Companies Act of 2008.[14] Section 252 aims to protect a member of a company from conduct that is unfairly prejudicial, unjust or inequitable.

Whether the conduct of the respondent constituted unfair prejudicial conduct was not in issue in the constitutional court. The main contention centred around what could be considered a preliminary question, namely whether the claims made in terms section 252 could be considered a debt in terms of the Prescription Act of 1969. If they could, the claim would have been extinguished by prescription. The whole matter turned on the definition of debt. In *Escom* a debt was defined as that which is owed or due – anything (such as money, goods or services) which one person is under obligation to render or pay to another.[15] On this basis the applicants argued that their claim could not be considered a debt as the order was declaratory in nature.[16] In terms of section 252 the relief sought merely alters the terms of a contract and is not a money award.[17] The respondents rejected this argument averring that the court should make a determination based on the ultimate effects or aims of the relief sought.[18]

[14] As section 252 forms the basis of this section cases that will be discussed under this section we will repeat the provisions in full. The section states as follows:
(1) Any member of a company who complains that any particular act or omission of a company is unfairly prejudicial, unjust or inequitable, or that the affairs of the company are being conducted in a manner unfairly prejudicial, unjust or inequitable to him or to some part of the members of the company, may subject to the provisions of subsection (2), make an application to the court for an order under this section.
(2) Where the act complained of relates to –
a. Any alteration of the memorandum of the company under section 55 or 56
b. Any reduction of the capital of the company under section 83
c. Any variation in respect of shares of a company under section 102; or
d. A conversion of a private company into a public company or of a public company into a private company under section 22

an application to the Court under subsection (1) shall be made within six weeks after the date of the passing of the relevant special resolution in connection with the particular act concerned.
(3) If on any such application it appears to the Court that the particular act or omission is unfairly prejudicial, unjust or inequitable or that the company's affairs are being conducted as aforesaid and if the Court considers it just and equitable, the court may with a view to bringing an end to the matter complained of, make such order as it thinks fit, whether for regulating the future conduct of the company's affairs or for the purchase of the shares of any members of the company by other members thereof or by the company and, in the case of a purchased by the company, for the reduction accordingly of the company's capital or otherwise.

[15] par 31.
[16] par 33.
[17] par 34.
[18] par 34.

This was rejected by the court because the court considered it to encompass a complicated causal or psychological enquiry that would lead to disparate results in similar claims of the same nature.[19] As stated above the supreme court of appeal's reasoning was based on *Desai*. The court in *Desai* gave a wide meaning to the term debt, including within its definition any obligation to do something or refrain from doing something.[20] This definition was overruled in *Makate* by the constitutional court when it determined that the "proper meaning of a debt" does not warrant a wide and general meaning.[21] The court, relying on section 39(2) of the constitution, determined that a debt should be interpreted in a manner that is least intrusive of the right of access to courts. To this end the court stated that: "to the extent that *Desai* went beyond what was said in *Escom*, it was decided in error. There is nothing in *Escom* that remotely suggests that debt includes every obligation to do something or refrain from doing something apart from payment or delivery."

The majority thus found that a section 252 claim could not constitute a debt.[22] Section 252(1) and (3) imbue the court with the power to make a judicial determination that is just and equitable.[23] The wide discretion given to the court will allow it to counteract any unfairness that may arise due to an applicant taking an unreasonably long time to enforce a claim in terms of section 252.

There were two minority judgments in this case. Justice Froneman (with Mbha and Musi AJJ concurring), whilst agreeing with the granting of leave to appeal, disagreed with the majority's interpretation that section 252 could never be interpreted as a debt that would prescribe.[24] Essentially Froneman J favours a more purposive approach to the claims made under section 252. He states that there may be circumstances where a claim made under section 252 does not constitute a debt but there may also be many more instances in which the claims sought do constitute a debt. The prayers in the notice of motion in this particular case contain examples of both types of claims. The claims made on the basis of section 252 should thus be considered separately.

The minority judgment by Justice Madlanga follows similar reasoning to that of Froneman J. While agreeing with the outcome of the case (the granting of leave to appeal), Madlanga J is of the view that the substance of the claim must be considered and not the procedural application on which it is based. Accordingly, a determination on whether a claim was a debt could only be made on a claim by claim basis.[25]

In our view the judgment of the court in *Off-beat Holiday Club* with regard to section 252 will also apply to section 163 of the current Companies Act. One of the major differences between sections 163 and 252 is that the new provision contains a long but non-exhaustive list of possible orders that the court can

[19] par 34.
[20] par 44.
[21] par 44.
[22] par 51.
[23] par 53.
[24] par 76.
[25] par 105.

make. Of particular relevance in this case would be the following relief under section 163(2): an order to regulate the company's affairs by directing the company to amend its memorandum of incorporation or to create or amend a unanimous shareholder agreement;[26] an order directing an issue or exchange of shares;[27] an order directing the company or any other person to restore to a shareholder any part of the consideration that the shareholder paid for shares, or pay the equivalent value with or without conditions;[28] and an order varying or setting aside a transaction or an agreement to which the company is a party and compensating the company or any other party to the transaction or agreement.[29] If the application was based on the 2008 Companies Act and if the applicants had based their prayers on the paragraphs mentioned above, could the claim have been deemed to be a debt? According to the majority this would not be the case. The dissenting judgments would for the most part agree, except in relation to an order for compensation.

The oppression remedy under the 1973 Companies Act was also at the centre of the 156-page judgment in *De Sousa v Technology Corporate Management*.[30] Despite the length of the judgment in which Boruchowitz J (having to delay his retirement) was scathing of the defendants,[31] this matter represents the quintessential case of a partnership in corporate form gone wrong. The plaintiffs were dismissed from the first defendant and sought to have their shares purchased by either the company itself or any of the shareholders.[32] The defendants, instead of dealing in good faith,[33] sought over a number of years to drive down a possible valuation of the shares of the company.[34] Their actions included writing off millions of rands worth of stock belonging to the company from the company's books and attempting to have an entire division of the company reflect as belonging to a third party,[35] in so doing separating the financial statements of that division from the rest of the company. During this time they also refused the plaintiffs access to the financial statements they needed to accurately value their shares.[36] Almost a third of the judgment is devoted to outlining and commenting on individual acts, transactions or tactics the defendants engaged in. It will be difficult to find a clearer example of oppressive and prejudicial conduct and the outcome would have been the same under section 163 of the 2008 Companies Act.

We are grateful that at least one case in the past year applied the oppression remedy in terms of section 163. In *De Klerk v Ferreira*[37] the concepts of "related"

[26] s 163(2)(*d*).
[27] s 163(2)(*e*).
[28] s 163(2)(*g*).
[29] s 163(2)(*h*).
[30] 2016 6 SA528 (GJ).
[31] par 89.
[32] par 137.
[33] par 149-150.
[34] par 334.
[35] par 333 and 335.
[36] par 154.
[37] 2017 3 SA 502 (GP).

and "inter-related" persons and of "control" introduced under section 1 of the Companies Act of 2008 were central to the determination.[38] These concepts are used in various provisions of the act aimed at preventing the abuse of special relationships between companies and those controlling them and protecting the interests of non-controlling stakeholders, for instance section 75 that requires the disclosure of personal financial interests by a director or anyone *related* to the director who the director knows has a personal financial interest in the matter. Section 44 that deals with financial assistance for the acquisition of securities in a company or any *related* or *inter-related* company provides a further example. The oppression remedy in terms of section 163 refers to an act or omission, by the company itself or by a *related person*, the result of which oppresses, unfairly prejudices or unfairly disregards the interests of the applicant. The determining factor for relationships with juristic persons is direct or indirect control. The manner in which each type of juristic person can be controlled depends on the nature of that juristic person. A company, for instance, is controlled by an individual or a juristic person who alone or in conjunction with related and interrelated persons can exercise or control the majority of the voting rights in it or who can appoint, elect or remove directors who have the majority of the votes in the board. A person who can influence the policy of a company in a way similar to someone who has control of the voting rights or board of directors, also controls that company.

A company is related to:

- an individual or juristic person controlling it through voting rights in the
- general meeting or the board or in a similar manner as someone who has such power;
- its holding company or subsidiary; and
- another company being controlled by the same person who controls it (this means that companies A and B are related if both of them are controlled by X).

Interrelated refers to three or more persons who are related in an uninterrupted series of relationships.

In *De Klerk* two entities formed the basis of the dispute: one was a close corporation and the other a private company. The case is of particular interest because the oppressive or unfair conduct only took place with regard to the corporation and not the company. In the case of close corporations the applicable remedy in cases of deadlock or unfair conduct are sections 36 and 49 of the Close Corporations Act of 1984.[39] The applicant having successfully relied on these sections could thus claim for the transfer of the members' interest in the corporation. However, the transfer of the members' interest in the corporation

[38] s 2.

[39] See further the well-known cases on these aspects *Gatenby v Gatenby* 1996 3 SA 118 (E) and *De Franca v Exhaust Pro CC* 1996 4 All SA 503 (SE) that provide thorough overviews of these sections.

alone would not completely resolve the acrimony between the parties as the affairs of the corporation and the company were inextricably linked and the parties were equal "partners" in both entities. An equitable resolution to the dispute would have had to involve both the company and the corporation. Although section 49 directs a court to make any order that it deems fit, the court rightly held that this was only in relation to close corporations and could not be extended to cases where the prejudicial conduct complained of was that of a company.[40] The court could therefore not on the basis of section 49 order the shares in the company to be transferred in the same way as the members' interest. The applicant contended that because of the inextricable link between the corporation and the company an order should be made on the basis of section 163.[41] Again the court disagreed: even if the entities for all intents and purposes functioned as one economic unit, this alone did not justify the use of the remedy in terms of section 163.[42] The correct enquiry was whether the corporation and the company were "related persons". In terms of section 2(2)(*a*) to (*c*) a juristic person could be related to another juristic person if another person controls the majority of the voting rights of both companies or could appoint the majority of the directors to both companies. This was manifestly not the case here. This left only a determination in terms of section 2(2)*(d)*. The relevant question in terms of this section was whether the defendant could materially influence the policy of both entities. If he could do so in the same way that a person could in majoritarian situations then he would be deemed to have control of the company.[43] Control with regard to this section must be understood in a manner beyond corporate law principles.[44] The necessary consideration in the case of control is factual. If the defendant could materially influence the policy of the company and the corporation then he had control of both entities. If he had control of both entities, they are related.[45] As the plaintiff was an absent shareholder residing primarily in Canada and had left the day to day activities of both entities to the defendant this element was present. In principle they both may have had *de jure* control in terms of their agreement but it was in essence the defendant who had *de facto* control.[46] The entities were thus related and an order sought in terms of section 163 was appropriate.[47].

2.2 The derivative action

The derivative action, as codified in section 165, is aimed at protecting the legal interests of the company. The terminology recognises that the right of action is "derived" from the company. It is in effect litigation conducted for the company by a representative litigant. The rationale for derivative proceedings is that the

40 par 77.
41 par 75.
42 par 76.
43 par 80.
44 par 80.
45 par 81.
46 par 84.
47 par 84.

company, which is the "proper plaintiff" because its interests are at stake, fails to take action. It is not a mechanism a litigant can use to assert or protect his or her own legal interests.[48]

Lewis Group Ltd v Woollam was an application by a listed company to have the court set aside a shareholder's demand that the company commence proceedings to have some of its directors declared delinquent.[49] Such a demand under section 165(2) of the Companies Act is the first step in the institution of a so-called derivative action. If the company declines to institute proceedings, the person who made the demand can approach the court for leave to institute proceedings on behalf of the company. The court can, however, set aside the demand in terms of section 165(3) if the demand is frivolous, vexatious or without merit.[50] The shareholder sought to use the derivative action in terms of section 165 to obtain an order of delinquency against the directors in terms of section 162. The provisions on delinquency of directors in section 162 are enacted in the public interest. It concerns the public law status of the allegedly delinquent person. This is underlined by the fact that the consequences of such an order are not restricted to the directorship of a particular company: the delinquent director will be disqualified from serving as director of any company. While in several other countries proceedings for the disqualification of directors can be instituted only by regulators,[51] the 2008 Companies Act also allows the company, directors, shareholders, and employee groups to apply to have directors declared delinquent or placed under probation. As both the company and a shareholder are expressly allowed to apply for a delinquency order, it is clear that the right to apply belongs directly and personally to the shareholder. This right exists in parallel with the identical rights of the company and other possible applicants to bring an application. An application to declare directors delinquent is thus not "derived" from the company's right of action.

The allegations against the directors related to business and accounting practices in the group. The shareholder who made the demand had acquired his shares in the listed company shortly before taking this step. He wrote two reports about the practices he objected to and distributed these to the investing public prior to the company's annual general meeting. This adversely affected the company's share price. The company alleged that the shareholder was acting in bad faith and had engaged in this conduct in order to manipulate the share price as he had taken short positions on those shares (meaning that he would benefit from a drop in the price).[52]

There are separate remedies that the company can use to protect its direct interests, such as removing the director from office in terms of section 71 and

[48] This refers to the proper plaintiff rule in terms of *Foss v Harbottle* (1843) 2 Hare 461. 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).

[49] 2017 1 All SA 231 WCC.

[50] par 92; see further *Van Zyl v Loucol (Pty) Ltd* 1985 2 SA 680 and *Thurgood v Dirk Krugers Traders (Pty) Ltd* 1990 2 SA 22 (E).

[51] par 91; see for instance the legal regimes of many countries in the Commonwealth including Australia, Canada, the United Kingdom and Canada.

[52] par 84-85.

holding the director liable for loss or damage caused to the company. The company could apply for delinquency even after it has exercised these other remedies. This illustrates that the right to apply for delinquency is distinct from the remedies the company might exercise to protect its own legal interests. A shareholder should ordinarily not be allowed to use derivative proceedings to obtain a delinquency order against a director.[53] There would have to be unusual circumstances to justify such proceedings, such as where the company has started with an application and incurred costs, but then failed to proceed. It might make sense in such a situation to allow the shareholder to proceed on a derivative basis rather than start new proceedings personally.[54] The demand by the shareholder was held to be vexatious because there was nothing to indicate why derivative proceedings were warranted for what he could claim in his personal capacity.[55]

In any case, the allegations against the directors did not in the court's view support a delinquency order.[56] The only ground that might be applicable in this case is that the directors carried on the company's business recklessly, with gross negligence, with intent to defraud any person, or for any fraudulent purpose, or acquiescence in the conduct of the company's business in that manner (section 162(5)(*c*)(iv)). This ground implies misconduct of a very serious nature. An analysis of the allegations revealed no cognisable case for a delinquency order, which meant that the demand also lacked merit.

The company's allegation that the respondent was acting in bad faith would be more relevant in subsequent proceedings when the court is asked to authorise derivative litigation. However, there is some overlap between the good faith factor and the question as to whether the demand is vexatious. The demand was set aside.

We tend to agree with this judgment. The court displayed a sensitivity to the core policy considerations underlying each of the two sections involved in this matter. Technically the shareholder could not immediately have applied for a delinquency order, as his name had not yet been entered into the securities register. However, as the court pointed out, it was a simple procedure to obtain registration. In the case of a demand under section 165, however, registration as shareholder is not required – a person who has the right to be registered as shareholder is expressly given standing.

A company that does not wish to comply with the demand has two options: taking immediate steps to have the demand set aside (as in this case), or indicating that it will not heed the demand. In the latter instance, the shareholder will then have to approach the court to obtain permission to bring proceedings on behalf of the company. The company's decision is a tactical one which will certainly be influenced by any adverse effect the demand and attendant publicity might have on the share price.

[53] par 49-50.
[54] par 51.
[55] par 52.
[56] See par 53, 61-62, 65, 66.

This was the second time in a year that Woollam had made a similar demand.[57] In response to the previous demand the Lewis Group applied for a setting aside under section 165(3) but before the matter was heard the shareholder withdrew the demand and offered to pay the wasted costs.[58] Lewis Group preferred to continue with the setting aside application as it was of the view that the court's decision on the merits would redress the reputational damage caused by the demand and also that it might prevent further demands by the same shareholder later on.[59] The issue to decide was whether withdrawal of a demand required the consent of the company. The court stated that the purpose of an application for the setting aside of a demand is to terminate the process and save costs. It is not aimed at addressing the company's reputation. This purpose provides the context against which the question must be answered. In the absence of any prerequisites for the withdrawal of a demand, the inference is that the company is not required to consent to withdrawal.[60] This inference is supported by the fact that the applicant has no duty to proceed after an investigation has indeed been conducted. It is only once the court has eventually given leave for the institution of proceedings on behalf of the company and the applicant has commenced such derivative proceedings that the court's consent is required to withdraw or settle the claim. The ability of an applicant to withdraw a demand does not thwart the purpose of the provision. If the issues raised by the demand indeed have merit, a withdrawal would not prevent the company from investigating that matter and taking action if necessary. In view of the withdrawal in this instance there was no live issue for the court to decide. It is an established principle that a court will not decide a moot issue.[61] The Lewis Group application was thus unsuccessful. We regard this judgment also as correct. Activist shareholders can clearly put companies to some trouble by demanding that the company institute proceedings. Woollam has been granted leave to appeal to the supreme court of appeal against the setting aside of the demand in the first matter we discussed.

The *Mbethe* case with its focus on the principle of good faith in private companies could be especially relevant in present day South Africa.[62] The case considered the good faith requirement of section 165. The substantive requirements of section 165 entail that the applicant act in good faith with regard to a matter that is of serious consequence to the company and that it is in the best interest of the company that proceedings are commenced.[63] The court discussed the principles in great detail including the issue of where the onus to prove good faith lies.[64] The Australian case of *Swanson v RA Pratt Properties (Pty) Ltd* is referred to by the court with approval.[65] *Swanson* set out a

[57] See also *Lewis Group Ltd v Woollam* 2017 2 SA 547 (WCC).
[58] par 3.
[59] par 3; par 15. This fear was, of course, warranted.
[60] par 11.
[61] par 13.
[62] *Mbethe v United Manganese of Kalahari (Pty) Ltd* 2016 JOL 35242 (GJ).
[63] s 165(5)(*b*).
[64] par 154-189.
[65] 2002 NSWC 583.

two-pronged test for the determination of good faith.[66] First the applicant must honestly believe that a good cause of action exists and that it has a reasonable prospect of success, and the applicant must show that the application is not brought for a collateral purpose. In *casu* the applicant's case was dismissed as the application, despite an attempt to show other underlying reasons, was brought only in order to preserve a contract that had been awarded to a close associate of the chairman of the respondent.

2.3 The appraisal remedy

The inclusion of *Loest v Gendac*[67] in this contribution provides us with the opportunity to discuss all the major remedies available to shareholders for the protection of minority rights. The appraisal remedy was invoked because of an alteration to the memorandum of incorporation of the company which amended the rights, preferences and other limitations attached to the shares. The applicant, a minority shareholder in the company, opposed the amendments but they were nevertheless adopted, prompting the applicant to make use of his appraisal rights in terms of section 164. The applicant essentially sought, through the use of section 164 of the Companies Act of 2008 and section 50 of the Promotion of Access to Information Act (PAIA), to allow the company to provide him access to certain financial information in order to have an accurate valuation of his shareholding. Two issues of importance were raised in this matter. The first is whether a shareholder is still a shareholder after a request is made in terms of section 164. If during this period the shareholder has ceased to be a shareholder, he would not be able to exercise any rights such as in this case requesting financial information. The respondents challenge to the status of the applicants was based on section 35(5) which states that if shares have been "surrendered" to the company they have the same status as shares that have been authorised but not issued.[68] The court did not deal with this in detail but it appears that surrender envisions the situation where the shares have already been taken up by the company. As such we do not believe that section 35(5) applies during the interim period between a demand and the finalisation of the appraisal process. Section 164(9) may be better suited to the interpretation of the respondents. It provides that a shareholder who sent a request to the company for appraisal has no further rights with regard to those shares except to be paid fair value.[69] We agree with the court's interpretation of this provision to the effect that the shareholder remains a shareholder but that the trappings and privileges of being a shareholder, for instance voting at meetings, are suspended.[70] The court also had to make a determination on whether section 164 could be used to compel the company to release certain

[66] par 153. This case was quoted with approval in *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 5 SA 74 (KZD).
[67] 2017 4 SA 187 (GP).
[68] par 13.
[69] par 13.
[70] par 13.

financial information in terms section of section 50 of PAIA.[71] The question essentially was whether, once a shareholder had invoked his appraisal rights, he was still entitled to make use of other remedies or procedures for the exercise of those appraisal rights.[72] The court resolved that section 164 had certain in-built mechanisms that protect shareholders' right to receive fair value for their shares.[73] This would include allowing a court to summon both parties and to ask both parties to produce documentation in order to assist the court in making this determination.[74] The right of access to information in terms of PAIA would also be one of these mechanisms.[75]

3 *Deregistration and reinstatement*

In *Palala Resources (Pty) Ltd v Minister of Mineral Resources*[76] the court had to consider the interaction between section 56(c) of the Mineral and Petroleum Resources Development Act (MPRDA), which provides that prospecting and mining rights lapse upon the deregistration of a company, and section 73(6A) of the 1973 Companies Act, which provided that when a company's registration was restored the company was deemed to have continued in existence as if it had not been deregistered. Palala Resources obtained a prospecting right in May 2009, valid for two years. It was deregistered in July 2010 for failing to submit annual returns but its registration was reinstated in September 2010. During the period of deregistration, a prospecting right over the same property was granted to Hectocorp, who was also a party to this case.[77] Hectocorp argued that the MPRDA had to prevail and that rights and licences granted under it were incapable of being revived retroactively. The court pointed out that restoration under section 73(6A) of the Companies Act of 1973 has automatic and full retroactive effect. There is no basis for a distinction between mineral rights on the one hand and all other forms of property of the other. There is no conflict between the MPRDA and the Companies Act. Section 56(c) determines the fate of mining rights when a company is deregistered. The Companies Act addresses the effect of restoration. If the legislature intended a different arrangement for mineral rights in the event of a company's restoration, it could have regulated the fate of mineral rights upon reinstatement of a company's registration so that rights would lapse finally regardless of reinstatement.[78] It is clear that the retroactive effect of reinstatement can be prejudicial to third parties, the court said. This is the position in relation to all forms of property and is regarded as unavoidable. A refusal to validate corporate activities during deregistration can be similarly prejudicial to third parties. The court declared that the prospecting

[71] par 17.
[72] par 38.
[73] par 40.
[74] par 24.
[75] The fact that the application collapsed because the applicant did not meet the requisite requirements of section 50 of PAIA is not directly relevant here.
[76] 2016 6 SA 121 (SCA).
[77] par 3.
[78] par 11.

right granted to Palala Resources was retrospectively restored to it. This meant that its earlier application for the renewal of the right could now be considered. The Minister was ordered to take the necessary steps to give effect to the order.

Although the court had to consider the effect of the 1973 Companies Act, reference was made to section 82(4) of the 2008 Companies Act and the supreme court of appeal decision in *Newlands Surgical Clinic (Pty) Ltd v Peninsula Eye Clinic (Pty) Ltd*[79] to the effect that reinstatement automatically has full retrospective effect.[80] Brand JA held in this case:

> "As I see it, the wording of the section leaves no room for the pragmatic approach adopted by the court a quo. The only meaning available on that wording, as I see it, is that section 82(4) has automatic retrospective effect, not only in revesting the company with its property but also in validating its corporate activities during the period of its deregistration. In short, there is no textual basis to distinguish between revesting of property and revesting the company with the capacity to continue operating."

It is thus clear that the position under the 2008 Act will be the same. However, a person who suffers prejudice as a result of automatic retroactivity can approach the court for relief under section 83(4), as was explained in *Newlands Surgical Clinic (Pty) Ltd v Peninsula Eye Clinic (Pty) Ltd*.

Applicants for prospecting and other rights might benefit from investigating the status of earlier holders of those rights. If the rights became available as a result of a deregistration there is a very real risk that those rights could be lost again through reinstatement of the erstwhile holder. This risk should also be taken into account by those financing prospecting and mining activities.

We do not agree with this judgment. While it makes sense for rights to revest in a company if they have lapsed due to deregistration, the position must differ if someone else has obtained those rights in the interim. There is in our view a distinction between mineral rights that lapse upon deregistration and other property that continues to exist but vests in the State as *bona vacantia.*

Aquila Steel (South Africa) Ltd v Minister of Mineral Resources[81] dealt fundamentally with the same issues grappled with in *Palala*. This matter involved a dispute on prospecting and mining rights of competing applicants and it dealt with various provisions of the MPRDA which are not relevant for our purposes. One of the companies involved in the dispute was a UK company dating from 1893, currently named Ziza Limited. The relevant issue concerns the legal effect that its deregistration in 2010 and particularly its subsequent reregistration in 2014 on the companies register of England and Wales had on a prospecting right granted to it. The status of that prospecting right impacted on the position of Aquila Steel. In *Palala* the SCA held that mineral rights, which according to section 56 of the MPRDA lapse when a company is deregistered, are automatically revived when the company's registration is restored. The court found that the difference between *Palala* and the current matter is that in *Palala* the right was

[79] 2015 4 SA 34 (SCA).
[80] par 7.
[81] 2017 3 SA 301 (GP).

still current and could revest in the company upon its reregistration.[82] However, in this matter the prospecting right had lapsed due to the expiry of the time for which it had been granted. It is important to consider what the concept of "revesting of property" entails.[83] If, while a company is deregistered, the property it previously held ceases to exist (eg its sack of potatoes is consumed or its tin of paint is used to coat someone's property) the law cannot treat that property as revesting in the restored company. The legislative deeming provision that treats the company as having continued in existence despite its deregistration cannot undo the transfiguration or destruction of property.[84] The rights conferred by a prospecting right cannot survive the expiry of the period for which the right was granted. The restoration of the company accordingly does not result in the revesting of the expired prospecting right. This judgment is clearly correct. If the company had remained registered it would likewise no longer have held the prospecting rights – the restoration of registration can at most place the company in the position it would have enjoyed if it had remained registered. The MPRDA provision on lapsing of rights applies to any deregistration, not only to South African companies holding rights. It refers to deregistration of a company or close corporation deregistered under the "relevant acts". But it is interesting to note that the court simply applied case law on the legal effect of deregistration and reinstatement under the South African provisions to this particular external company that had undergone these processes in the UK and the status of which must depend on UK law. In the particular circumstances the final outcome would be the same regardless of whether or not automatic revesting happens under UK law.

4 *Shareholders*

4.1 Proxies

In *Barry v Clearwater Estates NPC*[85] the memorandum of association of the Clearwater Estates home owners association required proxies to be deposited at least 48 hours prior to a meeting, otherwise the appointment would be void. Barry asked the court to set aside resolutions taken at a meeting where late proxies had been accepted. He argued that in view of the invalidity of the proxies there was no quorum. Clearwater Estates asked the court to find that the provisions of its memorandum of incorporation were inconsistent with the Companies Act and thus void.

Section 58(1) of the Companies Act stipulates that a shareholder may appoint a proxy "at any time". Section 58(3)(*c*) provides that the appointment document must be delivered to the company or to a person on its behalf "before" the proxy may exercise the shareholder's right to participate in and speak and vote at the meeting. Barry argued for a distinction between the appointment (which could

[82] par 98.
[83] par 99.
[84] par 100.
[85] 2017 3 SA 364 (SCA).

be made at any time) and the exercise of rights at a particular meeting (which could be subject to compliance with timely lodgement of documents with the company.[86] The argument that appointments as such could be separated from the effective exercise of a proxy's rights relies on a distinction that would make no sense, according to the court. The two provisions must be read together and their purpose must be achieved. There is no point in having a proxy unless that person can participate in and vote at a meeting.[87] Although section 58(3)*(c)* allows the memorandum to provide "otherwise" than that a copy must be delivered to the company before exercise of the right to participate, the flexibility is constrained by the unalterable provision in section 58(1) which allows appointment "at any time". The words used in section 58 differ from the corresponding provisions of the 1973 act in two important respects: first, the "at any time" has been inserted and second, the provision which invalidated provisions requiring lodgement more than 48 hours prior to a meeting, has been deleted. This signifies a clear change of intention in the act. The court found that proxies must be accepted at any time, even during a meeting. If this new principle is unworkable in large companies, the court said, the legislature will have to amend the Companies Act. The provisions of the MOI of Clearwater requiring proxy instruments to be lodged at least 48 hours prior to a meeting were found to be inconsistent with the Companies Act and accordingly void.

This judgment can cause inconvenience for large companies with many shareholders. Many companies would still have similar provisions in their memorandums of incorporation, particularly since this is exactly what the model articles in Table A article 51 and Table B article 52 provided. Clearly now any time limit imposed by the memorandum will be invalid and companies will have to recognise "late proxies" with immediate effect. The verification of the right of persons to participate in and vote at a meeting either as shareholder or as proxy can become complex where shares are held by layers of nominees and intermediaries on behalf of the beneficial holder. In listed companies, the uncertificated share environment depends on large scale nominee holdings by the central securities depository participants. The company might need its transfer secretary to be in attendance throughout the meeting so that registers and sub-registers can be checked against the appointment documents.[88]

The distinction between unalterable and alterable provisions is one of the pillars of the Companies Act. The memorandum may not detract from an unalterable provision. An alterable provision expressly contemplates that the memorandum can establish an alternative arrangement. Many of these provisions are introduced by the expression "except to the extent that the Memorandum of Incorporation of a company provides otherwise" but others are more specific by indicating the particular aspect that is alterable, for example, that the memorandum may

[86] par 16.
[87] par 16.
[88] Section 5(6) provides that the listing requirements of an exchange will prevail in the event of a real conflict between the Companies Act and the exchange rules. However, the rules of a central securities depository govern the voting rights of uncertificated shares.

fix a longer and/or shorter time period or a higher and/or lower number. This judgment establishes an important principle regarding the apparently broader type of alterable provision: the scope of alteration is constrained by any relevant unalterable provision. A court will not rely on the mere fact of alterability to limit the interpretation of the unalterable provision. A provision in the memorandum that is inconsistent with the Companies Act, is void. While it is not strictly necessary to remove the redundant provision from the memorandum, this would be advisable. Companies should thus give attention to the removal from their memorandums of incorporation of any time restrictions for the delivery of proxy instruments. A good suggestion may also be that companies, in notices of meeting, request shareholders to deliver proxy appointments in good time.

4.2 Subscription for shares

Du Plooy v De Hollandsche Molen Share Block Ltd[89] dealt with whether persons that had subscribed for shares but never took up those shares, upon the initial incorporation of the company, could be considered to be shareholders of the company and thus able to transfer those shares to a third party. Common practice under the Companies Act of 1973 was to have employees of the registering attorney act as subscribers to a public company for the purposes of incorporation. Once the company was formed any shares held by the employees were transferred. The agreement to transfer the shares were usually signed with the registration documents.[90] The shares that were in dispute were shares that were widely believed by the company and all concerned parties, since at least 2004, to belong to the Du Plooy Trust, the majority shareholder in the shareblock scheme. The current dispute arose because upon conversion by the company into a company compliant with the Companies Act of 2008, it was discovered that the trust was never entered into the share register of the company and neither were the applicants from whom the trust purported to have received transfer of the shares. The matter turns on two questions: the status of the original subscribers to shares in the first respondent and the transfer of shares from the employees to the applicants. In answering the first question, the argument for the applicants which the court accepted was that upon the incorporation of the company, the subscriber applicants became shareholders of the company, without more*,* as was set out in the association clause in the memorandum.[91] The court relies on various authorities in reaching this conclusion.[92] The position as it appears from the judgment is that the initial subscribers in the company become members of the company, and although the act may require registration in a share register, neither this nor the allotment of the shares is a condition precedent to their membership.[93] The second question

[89] 2017 3 SA 274 (WCC).
[90] par 29.
[91] par 19.
[92] par 19-26; see *Moosa v Lalloo* 1957 4 SA 207 (N) and Delport (ed) (Loose-leaf) *Henochsberg on the Companies Act 71 of 2008* par 15.
[93] par 26-27.

in reality concerns ownership of the shares. It explores the question whether it is in essence necessary for persons to be registered in the share register of the company in order to be considered shareholders. This question would appear to be settled law already.[94] Davis J refers to a passage from *Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd* in making this determination:[95]

> "A nominee is an agent with limited authority: he holds shares in name only. He does this on behalf of his nominator or principal, from whom he takes his instructions. The principal whose name does not appear on the register, is usually described as the beneficial owner. This is not, juridically speaking accurate: but it is a convenient and well understood label. Ownership of shares does not depend upon registration."

The shares were found to have been validly transferred to the trust from the applicants and the court declared in terms of section 161 that the trust was the valid owner of all shares that were in dispute.

4.3 Conditional takeover offers

Country Bird Holdings Ltd v Sovereign Food Investments Ltd[96] considered whether a general takeover offer made by Country Bird Holdings (CBH) to the shareholders of Sovereign in July 2016 had lapsed or could be accepted. There were several conditions precedent, including regulatory approval under competition law and takeover law. The offer was also conditional upon sufficient acceptances to give CBH and parties acting in concert with it a majority of the votes in Sovereign. Regulation 103(4) provides that a general offer lapses if it has not been declared unconditional as to acceptances by midnight on the 45th business day after the opening date. However, CBH realised it would not get 50 per cent plus 1 share by the last date and then purported to waive the condition the day before it would lapse under regulation 103(4). Sovereign attacked the lawfulness of the waiver. Although a party can usually waive a condition imposed in its favour, the panel explained that takeover offers fall under a specific regulated environment taking them out of the bounds of contract law. The purpose of takeover regulation is to ensure the integrity of the market place and the provision of information to shareholders is a central pillar of fairness to shareholders. In this case the firm intention announcement did not draw the attention of shareholders to the possibility of a waiver, which was an essential aspect of offer. The market initially acted upon one set of circumstances, factoring in the condition. However, if the waiver was valid and the offer thus remained open, those who had not yet made up their minds faced a different market reality. Also, it was possible that some shareholders might have accepted because they thought the threshold for the fulfilment of the condition would in any event not be achieved. The panel thus relied on general principles underlying takeover regulation to rule that the offer had lapsed due to the non-fulfilment of the condition by the cut-off date. It was not necessary to decide whether a waiver would have been possible if properly disclosed as a possibility.

[94] par 33.
[95] 1976 1 SA 441 (A).
[96] Takeover Regulation Panel ruling 8 November 2016.

5 *Insolvent trading – director liability*

Chemfit Fine Chemicals (Pty) Ltd v Maake[97] was an application to hold directors of a company liable for "trading in insolvent circumstances". As the company was in business rescue and not in liquidation, reliance was placed on the 2008 Companies Act. Section 424 of the 1973 act applies only in a winding-up.[98] Chemfit provided credit facilities to the company that eventually went into business rescue. The credit facility was increased from time to time while the company's financial position deteriorated. The court accepted that the company had been in financial distress for over two years. Chemfit argued that if the company had complied with its contractual undertaking under the credit facility to inform it of its financial distress, it would not have extended the credit facility.

Chemfit wanted to hold the directors liable under section 218(2) of the Companies Act for damage in excess of R3 million. This provision imposes liability for loss or damage suffered as a result of any contravention of the Companies Act. The contraventions relied on included "trading in insolvent circumstances". The court found that the term "contravention" refers to a violation of or conduct repugnant to any provision of the act or regulations.

Alarmingly, the judgment is based on an outdated version of the Companies Act. This is clear from quoting the pre-amended version of section 22 which still contained a prohibition on trading in insolvent circumstances.[99] This provision was amended by the Companies Amendment Act 3 of 2011 with effect from the very day on which the main Companies Act first came into operation so the version used by the court was never in operation. In similar vein the court quotes the outdated version of section 214(1)(*c*).[100] The outcome would arguably have been the same had the court applied the current provision, because incurring further debt without a reasonable expectation of repayment has often been held to constitute reckless trading.[101] There was possibly enough evidence from which the court could have inferred reckless or at least grossly negligent trading in order to substantiate its finding of a contravention.

We are further not convinced that the court interpreted section 129(7) correctly. The board has to notify creditors when it knows the company to be financially distressed[102] and has decided against a business rescue resolution. However, we get the impression the judge thought directors should have sent out a notification at the time they decided to place the company in business

[97] 2017 ZALMPPHC 27 (1 September 2017).

[98] Although the Companies Act 61 of 1973 has been repealed, chapter 14 continues to apply to the winding-up of insolvent companies; see item 9 of sch 5 to the 2008 act. Dlodlo J recently got it wrong in *Collard v Jatara Connect (Pty) Ltd* 2017 ZAWCHC 45 (14 March 2017) when, based on the opening words of s 424, he remarked (par 25) that the provision applies "at any time" whether the company is under winding-up or not.

[99] par 23. This provision was previously s 22(1)(*b*)(ii). It is clear from several other references to this formulation that the court did not simply make a once-off error; see par 27 and 28.1. Currently trading while unable to pay debts can, however, lead to an enquiry by the CIPC under s 22(2).

[100] par 28.4.

[101] *Ex parte De Villiers NO: In Re Carbon Developments (Pty) Ltd (In Liquidation)* 1993 1 All SA 441 (A).

[102] as defined in s 129(1)(*f*).

rescue.[103] Instead, the judge should have enquired whether the directors previously had reasonable grounds to believe that the company was financially distressed (which could have been inferred) and at that stage decided against business rescue without informing the creditors of the reason for their decision.

As to section 22, the court said that despite the formulation prohibiting the *company* from so trading, it was clear that the directors were targeted. The court referred to *Rabinowitz v Van Graan*.[104] We are of the view that directors can indeed be held liable for contravening the section, although we would base their contravention on the normal principles of accessory liability rather than on agency as the court did.[105] But the court stated in so many words that it was not the company as an autonomous juristic person that contravened the act, "but squarely its directors".[106] This, of course, raises the question whether a company will ever incur liability for any wrongdoing.

The court concluded that on a "holistic reading" of the papers there were "sufficient facts" to show that there had been contraventions of sections 22, 77(3)(*b*), 214 and 218(2).[107] Curiously, the court did not again mention the contravention of section 129(7) and the regulations pertaining to notice to creditors of the company's financial distress.[108] We have already criticised the application of outdated versions of section 22 and 214. The effect of the amendment to section 214 was to substantially narrow the original offence from encompassing knowing participation in fraudulent, reckless or insolvent trading to being restricted to knowing participation in fraudulent trading. Allowing a company to trade in insolvent circumstances does not automatically justify a finding of fraud.[109] As to "contraventions" of the two provisions imposing liability – section 77(3)(*b*) and 281(2) – we doubt that a provision that simply declares when a person will be liable can be "contravened".[110]

6 *Business rescue*

Business rescue is still proving to be a popular field for litigation. The sets of conflicting judgments on certain important issues show just how difficult it can be to interpret chapter 6. Blame for this situation should probably be shared between the relative novelty of business rescue proceedings and the "shoddy" drafting of the Companies Act which has been criticized by the supreme court of appeal on more than one occasion.[111] Over the past few years this court has

[103] The formulation of the statement in this regard in par 28 leaves much to be desired.
[104] 2013 5 SA 315 (GSJ).
[105] See par 24.
[106] par 27.
[107] par 37.
[108] not to be confused with the contractual duty to disclose financial distress.
[109] *Ex parte De Villiers* (n 101).
[110] In the case of s 77(3) liability is to the company for loss or damage suffered by it and the case of s 218(2) to any person.
[111] *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd* 2015 5 SA 192 (SCA) par 43; *FirstRand Bank Ltd v KJ Foods CC (in business rescue)* 2017 3 All SA 1 (SCA) par 74.

had opportunity to solve several pressing issues. It has also demonstrated its willingness to boldly guide beyond what is strictly necessary, as is evident from both the supreme court of appeal decisions we consider here.

6.1 Business rescue plans: rejection, implementation, amendment and setting aside

When a proposed business rescue plan is rejected by the affected persons, one of the three steps that could follow is that a court may be approached to set aside the result of the vote on the basis that it was "inappropriate".[112] The court can do so if it is just and reasonable upon consideration of (a) the interests represented by the dissenters; (b) the provision made for those interests in the plan; and (c) the estimated return to the dissenters if the company were instead to be liquidated.[113]

The parties in *FirstRand Bank Ltd v KJ Foods CC (in business rescue)*[114] settled their dispute before the court handed down judgment, but requested the court to pronounce on the matter and so provide guidance on the basis for and the effect of such a setting aside. Although the judges agreed on the ultimate result, Seriti JA wrote a dissenting judgment.[115]

The plan proposed in KJ Foods envisaged full payment to both secured and unsecured creditors. While it provided for claims under instalment agreements and covering bonds to be repaid in terms of the original agreements, debts due to other creditors would be rescheduled and paid over 52 months.[116] In a liquidation, the plan indicated, concurrent creditors were likely to receive no more than 51 cents in the rand.[117]

FirstRand was the only creditor to vote against the proposed plan when it was put to the vote in December 2013. Two of its divisions, FNB and Wesbank, held secured claims against KJ Foods, giving it 29.81% of the creditor voting interests. It criticised the plan as vague and questioned the accuracy of the predictions and forecasts made.[118] In its view, the plan preferred concurrent creditors over secured creditors with long original repayment periods. Its dissenting vote meant that the plan was rejected.[119] The practitioners then applied to have the vote set aside as inappropriate and were granted such an order in October 2014. By the time the appeal was heard, the plan had been substantially implemented.

[112] The practitioner can apply under s 153(1)(*a*)(ii) and affected persons under s 153(2)(*b*)(i)(*bb*). The other options are a vote for the preparation and publication of a new plan (s 153(1)(*a*)(i)) and s 153(2)(*b*)(i)(*aa*)) or the making of a binding offer to purchase the votes of dissenting creditors (s 153(2)(*b*)(ii)).
[113] s 153(7).
[114] 2017 3 All SA 1 (SCA).
[115] Seriti JA wrote for the minority.
[116] par 13.
[117] par 37 and 84.
[118] It appears from par 58 and 62 of the judgment that FirstRand made an unsuccessful attempt to prove a further claim of R13 million in terms of a suretyship granted by KJ Foods and from par 62 that there was also a dispute about the application of an amount the DTI had advanced to settle an overdraft of KJ Foods.
[119] More than 75% is required; s 152(2)(*a*).

A report prepared by the practitioners shortly before the hearing of the appeal revealed the projected income and expenditure levels to have been accurate and confirmed that KJ Foods had adhered to the repayment schedule.[120] Whether any weight should be attached to the benefit of this hindsight is questionable.

The issues that had not been resolved by the different high courts were (a) whether or not it is necessary to determine separately that the result was "inappropriate" and that it would be reasonable and just to set aside the dissenting vote;[121] (b) whether inappropriateness entailed a subjective or objective enquiry;[122] and (c) whether setting aside of the vote resulted in the deemed adoption of the plan or in another round of voting according to the court's instruction.

The majority and minority judgments correspond in favouring an objective rather than a subjective notion of inappropriateness. The motive or good faith of the dissenter is irrelevant.[123] The result of the plan should be set aside if the rejection of the plan unduly undermines the rescue of the company. The position of other creditors and of employees must be considered. The court compared FirstRand's position under the plan not only with what it would receive on liquidation, when its claim would of course be settled much earlier than under the loan agreements, but also with its entitlement under the initial loan agreements.[124] As FirstRand's claim would be settled in full in all three scenarios, the only difference was *when* it would be paid. All the judges also agreed that the act does not envisage that the plan must be sent back to voting by affected persons with an order that it must be adopted.[125] The difference between the two judgments lies in the answer to the first question. The minority would adopt the two-stage enquiry[126] while the majority[127] sees the two concepts as inextricably linked so that a single enquiry and value judgment will determine the outcome: if it is reasonable and just to set aside the vote, based on objective factors, this will be done on the basis that the vote is inappropriate.[128]

In *Kransfontein Beleggings (Pty) Ltd v Corlink Twenty Five (Pty) Ltd*[129] the supreme court of appeal considered the burning issue of whether a court can amend or partially set aside a business rescue plan. This was an application for

[120] Wesbank's claim had been reduced from over R5.6 million to just over R400 000 while the FNB loan had gone down from R6.3 million to R5.3 million.

[121] In favour of a two-stage enquiry were, in addition to the court *a quo*, *Shoprite Checkers (Pty) Ltd v Berryplum Retailers CC (Murray NO, Mitateko, Shirelele NO Intervening Parties)* 2015 ZAGPPHC 255 (GP) (11 March 2015) par 40; *Ex Parte Target Shelf 284 CC (Commissioner for the South African Revenue Service and Business Partners Ltd Intervening Parties)* 2015 ZAGPPHC 740 (GP) (13 October 2015); *Ex Parte Bhidshi Investments CC* 2015 ZAGPPHC 783 (GP) (7 October 2015). See also *Collard v Jatara Connect (Pty) Ltd* 2017 ZAWCHC 45 (14 March 2017) which was decided only weeks before the SCA handed down judgment in *KJ Foods*.

[122] *Copper Sunset Trading 220 (Pty) Ltd v Spar Group Ltd* 2014 6 SA 214 (LP); *Collard v Jatara Connect (Pty) Ltd* (n 98).

[123] par 33.

[124] par 85.

[125] See par 41 (Seriti JA) and par 50 (Schoeman AJA). This was one of the orders in the court below.

[126] par 29.

[127] per Schoeman AJA with Mpati AP, Theron JA and Van der Merwe JA concurring.

[128] par 80

[129] 2017 ZASCA 131 (29 September 2017).

leave to appeal, and although the judgment could have been based solely on the procedural issue of non-joinder, the court asked the parties to address it on the merits.

Corlink operated a farming business and went into business rescue. Kransfontein had a claim of more than R7 million against Corlink, secured by a special notarial bond over specified farming equipment and livestock.[130] It first alerted the practitioners to its claim after a business rescue plan had been published but before the plan was voted on. A revised plan, reflecting a sale of the company's three farms,[131] also did not reflect Kransfontein's claim. It was adopted despite Kransfontein's opposing vote.[132] Kransfontein then made a costly strategic error: it first sought an interdict against the implementation of the plan and for its setting aside as a whole. The only creditors it joined as parties in this application were the two secured creditors Absa Bank and Griekwaland Wes Korporatief Bpk (GWK), the holders of mortgage bonds over Corlink's farms.[133] It then amended its relief so that only GWK, the holder of a second mortgage bond, would be impacted by the proposed order. The secured creditors had agreed to set aside, pending the outcome of the litigation, an amount equal to Kransfontein's secured claim. However, as it was not evident that GWK was prepared to absorb the loss and abandon the balance of its claim if Kransfontein succeeded,[134] the court assumed that GWK would then assert a concurrent claim for the balance. This would reduce the payment to concurrent creditors from 1.58 cents in the rand to 1.31 cents in the rand. Concurrent creditors thus had a direct and material interest in the litigation[135] and the fact that they had not been joined was fatal to Kransfontein's case.

The court also gave a second reason for denying relief to Kransfontein, namely that the act provided no basis upon which a court could partially set aside or amend a business rescue plan. It explained that the only plan that could be implemented by a practitioner was a plan adopted by the affected persons. We think that the business rescue procedure can benefit from the enactment of proper objection procedures for creditors in relation to the proof and admission of claims.

The assets over which Kransfontein held its special notarial bond were evidently sold together with the farms as going concerns. There is no indication that Kransfontein consented to the sale of the assets in the original auction or

[130] Even water rights were purportedly pledged, but the court correctly found that, being incorporeal, such rights cannot be pledged and thus also not be the subject of a notarial bond (par 2). Although not a company law or insolvency law matter, this is a convenient opportunity to insert a brief reference to *Factaprops 1052 CC v The Land Bank* 2017 4 SA 495 (SCA) where the supreme court of appeal ended uncertainty and ruled that the period of prescription for a debt secured by a special notarial bond over movable property is 30 years as it falls under the definition of a mortgage bond in the Prescription Act 68 of 1969.

[131] The farms were sold by public auction before the start of business rescue; see par 3. The amendment of the plan reflected the creditors' instruction that the sale should be implemented.

[132] It is not clear on what basis Kransfontein was allowed to vote despite the plan not reflecting its claim.

[133] After *Absa Bank Ltd v Naude* 2016 6 SA 540 (SCA) this was risky, but apparently a deliberate decision; see par 16.

[134] *ie* that it was a two-way fight (see par 20).

[135] although the court did remark that the difference was small; par 18.

to a disposal by the practitioner under section 134. We cannot help but wonder what the position would be if Kransfontein attacked the validity of the sale.[136]

In *Booysen v Jonkheer Boerewynmakery (Pty) Ltd*[137] another issue relating to the amendment of an approved plan arose for decision: whether a business rescue plan can empower a practitioner to amend the plan. The applicant proved a claim for incentive-based remuneration. The amount was reflected in the business rescue plan as a preferent claim which would, according to the payment schedule of the plan, be paid in full in the first distribution. But more than two years later Booysen was still waiting for his money. This was despite the fact that the other preferent creditors (retrenched workers) had received payment and that a large sum had been distributed to creditors in general. Eventually the practitioner indicated that he was disputing the amount of Booysen's claim as well as its preferential status. He further explained that the plan contained a proviso granting him the right to unilaterally amend it without creditor consent. Booysen brought proceedings to force the company and practitioner to make payment in accordance with the plan. The respondents argued that Booysen's claim should fail because of the general moratorium: he had not obtained the prior consent of the practitioner or the leave of the court for these legal proceedings.

The court considered the conflicting cases on the scope of the moratorium and manner in which leave may be granted. It disagreed with the *Moodley* case[138] that proceedings pertaining to the development and implementation of a business rescue plan were not covered by the moratorium. It avoided picking sides in the debate as to whether a specific formal request for leave was required and, if so, whether it had to be granted in separate prior proceedings or could be sought together with or subsequent to the launch of the main proceedings or enforcement action.[139] This, according to the court, depended on the circumstances. The purpose of the moratorium – to provide a temporary breathing space for the embattled company – must be borne in mind. However, given the fundamental right of access to justice, the effect of the moratorium should be restrictively interpreted while the options for obtaining leave should be generously constructed. The need for speed and efficiency in rescue proceedings indicate that a formal or separate application which might drag out the process is not always necessary. The court thus granted leave for the applicant to "proceed" with his application.[140]

Any pre-commencement claim related to employment is classified as preferent,[141] and this includes commission or incentive based remuneration.

[136] See *Energy Drive Systems (Pty) Ltd v Tin Can Man (Pty) Ltd* 2017 JDR 0301 (GJ), discussed below.
[137] 2017 4 SA 51 (WCC).
[138] *Moodley v On Digital Media (Pty) Ltd* 2014 6 SA 279 (GJ).
[139] par 62.
[140] We do not agree with the distinction drawn between continuation (other jurisdictions) and proceeding with the litigation or enforcement action; see par 61. "Commence or proceed" means the same as "commence or continue"; the latter term in each instance refers to the proceedings or enforcement action that commenced before business rescue started.
[141] s 144(2).

Booysen's claim was thus correctly reflected in the plan.[142] The court was emphatic that an adopted business rescue plan could not be amended unilaterally by the practitioner (in this case by adjusting the amount and status of a proven claim) and that the proviso in the plan was invalid. In line with what the supreme court of appeal subsequently said in *FirstRand Bank Ltd v KJ Foods CC*[143] the court explained that the act did not provide for amendments to a plan. It envisages control over the process by a democratic majority, relies on the approval procedure to confer binding force on a plan;[144] and obliges the practitioner to implement the adopted plan.[145] An order was issued that Booysen should be paid the amount reflected in the plan.[146]

The court was uncomfortable with the extent of control apparently exercised by the two directors and the passive attitude adopted by the business rescue practitioner, who is supposed to be more than a nominal figurehead.[147] It suspected that the practitioner was neglecting his role as an objective and impartial officer of the court, despite the handsome fee he would be paid. Accordingly, it directed that the CIPC should receive a copy of the judgment.

6.2 Suspension of liquidation proceeding

Tyre Corporation Cape Town (Pty) Ltd v GT Logistics (Pty) Ltd 2017 3 SA 74 (WCC) involved competing applications for winding up (by three trade creditors) and for business rescue (by the sole shareholder/managing director of the company). The company had been in provisional liquidation and the business rescue application appears to have been intended to prevent the making of a final liquidation order. The issue was exactly when liquidation proceedings are suspended[148] by an application for business rescue. According to section 131(6), this happens at the time when the business rescue application is "made" to court. In this case the application was lodged with the registrar and a case number issued on 29 February 2016. It was presented to court after the liquidation application had been argued. The application was served on the CIPC on 2 March 2016. It was never served on the company or provisional liquidator and the court accepted that not all creditors and employees had been notified of the application. The court was confronted with its own earlier judgment in *Blue Star Holdings (Pty) Ltd v West Coast Oyster Growers CC*[149] holding that "made" referred to the issuing of the case by the registrar but also referred to matters in other divisions, namely *Taboo Trading 232 (Pty) Ltd v*

[142] par 67. This may indicate that the court would be prepared to set aside the plan if it was based on an error.
[143] n 114.
[144] s 152(4).
[145] See s 152(5)(b).
[146] with interest from 1 May 2016. The application was launched on 24 June 2016 so it is unclear why this date was selected.
[147] par 68.
[148] under s 131(6).
[149] 2013 6 SA 540 (WCC).

Pro Wreck Scrap Metal CC[150] and *Absa Bank Ltd v Summer Lodge (Pty) Ltd*[151] which held that the application is made only once it has also been served on the CIPC and each affected person properly notified. The court emphasised the position of the provisional liquidator who would be unaware of the issuing of the application and his or her suspension and would thus continue administering the estate unlawfully. The court thus ruled that the launching of the business rescue application did not suspend the liquidation proceedings. The same approach has now also been followed in *Standard Bank of South Africa Ltd v Gas 2 Liquids (Pty) Ltd*[152] where the court held that notice of the application for business rescue must be served on the provisional liquidator before a suspension will take effect.

The question of control over the company's assets and affairs from the moment of suspension to the granting of a business rescue application arose again in *Maroos v GCC Engineering (Pty) Ltd*.[153] In *Van Rensburg NO v Cardio-Fitness Properties (Pty) Ltd*[154] the court had found that there was a lacuna and ruled that the liquidator or provisional liquidator had custody and control. The court in *Maroos* disagreed and found that the assets vest in the Master while control of the company reverts to the director. In this case a manager proposed by the director was appointed as his agent to manage the company. The court had little sympathy with the warning that abusive business rescue applications could be launched to frustrate liquidation proceedings.[155]

The judgment does not justify the distinction between control over the company's assets and the management of its affairs. Curiously, the court states that the "complete process" of liquidation is suspended in its entirety,[156] but it then nevertheless relies on section 361(2) of the Companies Act 61 of 1973 to find that the company's assets vest under control of the Master.[157] In a liquidation the directors are stripped of their control at the same time that control of the assets is deemed to vest in the Master, namely when the winding-up commences. It is not as if they remain in control of the company until the appointment of a provisional liquidator. The court fails to explain why the vesting, which must surely be part of the liquidation proceedings, is not also suspended or prevented. Or why, if it is only the provisional liquidator's position that is suspended, the position does not revert to what it was after an order was made but before a provisional liquidator is appointed. The order did provide that the appointed manager had to provide security for the proper management of the company and needed to obtain the consent of the master before he could sell any property. If suspension of liquidation proceedings is selective in nature,

[150] 2013 6 SA 141 (KZP).
[151] 2013 5 SA 444 (GNP).
[152] 2017 2 SA 56 (GJ).
[153] 2017 ZAGPPHC 297 (15 June 2017).
[154] 2014 ZAGPJHC 40 (4 March 2014). See also *Knipe v Noordman NO* 2015 4 SA 338 (NCK), but compare *Van Zyl v Engelbrecht NO* 2014 5 SA 312 (FP).
[155] par 16.
[156] See par 15.
[157] This section provides for such deemed vesting whenever the office of liquidator is vacant or the liquidator is unable to perform his or her duties.

courts will in future have to grapple with several other of the consequences of liquidation. When it comes to the transfer of shares, for example, will the liquidation provisions apply[158] or can transfer happen freely?

6.3 Secured creditors and the meaning of "title interest"

Energy Drive Systems (Pty) Ltd v Tin Can Man (Pty) Ltd[159] concerned the sale of the business of a financially distressed company, which is one of the common outcomes of business rescue. Tin Can Man purchased and took possession of over R35 million worth of movable assets from a company in business rescue. The assets were listed in annexures to the contract and were located on the business premises of the company. Among these items was a power saving energy drive system leased from Energy Drive Systems. It was installed on the premises and the contract contained a reservation of ownership clause.

Energy Drive Systems instituted the *rei vindicatio* to recover possession of its property from the purchaser. The court correctly found that Tin Can Man did not, under the general principles of the law of property, become owner of the property.[160] Tin Can Man had another argument, based on the Companies Act. It relied on section 134(3) which provides the business rescue practitioner with a right to dispose of property over which another person has a security or title interest. If the proceeds of the disposal will be sufficient to fully discharge the indebtedness due to the secured or title interest creditor, the consent of that creditor is not required.[161] The court remarked that the meaning of "title interest" in South African law has not been established and then proceeded to consider the dictionary meaning of its two components. Since "title interest" is used in the alternative with "security" it must be something other than security but which also protects an indebtedness. It concluded that a reservation of ownership is a common method of safeguarding the indebtedness under an instalment sale and that it is included in the concept "title interest". The practitioner thus has the right to sell the property of a creditor despite a reservation of ownership. However, the act requires the practitioner to promptly pay the debt from the proceeds or to secure the debt.[162] The court found this requirement to be a precondition for the transfer of ownership, explaining that the practitioner's right to dispose of property was not aimed at the destruction of the rights of secured creditors and holders of title interests. Tin Can Man did not acquire ownership, because Energy Drive had not received payment.

6.4 The general moratorium

Arendse v Van der Merwe NO[163] deals with the factors a court will consider in deciding whether to allow legal proceedings against a company while it is

[158] s 341(1) of the 1973 Companies Act.
[159] 2017 JDR 0301 (GJ).
[160] The distressed company could not transfer ownership if it was not the owner.
[161] s 134(3)*(a)*. Otherwise prior consent is necessary.
[162] s 134(3)*(b)*.
[163] 2016 6 SA 490 (GJ).

in business rescue. Legal proceedings and the enforcement action can be instituted or proceeded with only with the written consent of the business rescue practitioner or with the permission of the court.[164] The applicants were senior executives of a company in the Ellerine group and were seeking payment under a contractual incentive scheme. One of the intended co-defendants was African Bank, the ultimate holding company. Like the Ellerine companies, it had been placed in business rescue. While the business rescue practitioners of the Ellerine companies consented to the institution of legal proceedings, the business rescue practitioners of African Bank did not. The applicants accordingly approached the court for leave to institute legal proceedings against the bank. By the time the application was heard African Bank was no longer in business rescue and the moratorium had come to an end, but the court concluded that it would have granted leave.

The court explained that it had a wide discretion to grant leave to an applicant and that this power was not restricted to exceptional circumstances. The discretion should be exercised with regard to the purpose of the moratorium, which is to allow the business rescue practitioner to focus on restructuring the company without being distracted by legal proceedings. Nevertheless, the moratorium is intended to be temporary in nature and cannot be used to indefinitely delay or extinguish claims. The court stated that the applicants need not show that the legal proceedings will be successful, but only that they would have a triable case if they can prove the facts they are alleging. Although there is no closed list of factors a court can take into account, the court regarded the following factors as relevant: the effect that the court's decision will have on the rights of the applicants as opposed to those of other affected persons and stakeholders, the impact that the proposed legal proceedings will have on the company's well-being and prospects of financial recovery, and whether granting leave will be an obstacle to the object and purpose of business rescue proceedings.

[164] s 133(1).

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